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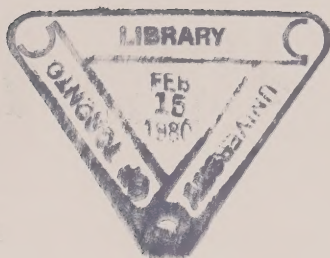
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THE CANADIAN AUTOMOTIVE INDUSTRY
— PERFORMANCE AND PROPOSALS FOR PROGRESS



INQUIRY INTO THE AUTOMOTIVE INDUSTRY
SIMON REISMAN, COMMISSIONER

OCTOBER, 1978



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PREFACE

This report has been prepared for the Government of Canada pursuant to a Commission under Part I of the Inquiries Act "to inquire into and report upon the means to ensure the development in Canada of a balanced and internationally competitive automotive industry". The precise terms of reference, the scope of the inquiry and certain guidelines governing the conduct of this Inquiry are contained in the Commission document reproduced at pages viii to xiii.

The Commissioner was to commence his work July 1, 1978, and he was directed to report his findings and recommendations to the Governor in Council through the Minister of Industry, Trade and Commerce before October 31, 1978. It was quite evident, therefore, that the government attached a particular urgency to this inquiry in an operational framework rather than as a scholarly work requiring comprehensive and time-consuming independent research. The choice of the Commissioner attests to this emphasis and explains the focus of this report, if not its length. If somewhat more time had been available the report could have been reduced considerably in size as well.

The fact that no more than four months were available for the entire work virtually determined the organization and the procedures for conducting the Inquiry. It was decided to confine the organization to a

small staff to assist the Commissioner; and to rely as far as possible on departments and agencies of the government for assistance. Background material was obtained mainly from published sources and independent research was confined to only the most essential needs. It was not expected that recourse would be required to the powers under the Inquiries Act, and friendly co-operation from all branches of the industry, in fact, assured that the Commission's need for confidential information became readily available on a voluntary basis.

Again, because of the compelling time constraints, it was decided not to conduct public hearings or to publish a solicitation for briefs. Instead a program of consultations was arranged with firms, organizations and governments which had a direct interest in the subject and wherever possible meetings were held in Ottawa. In addition, briefs were received from and meetings held with every organization or private individual that expressed an interest in participating in the Inquiry. This method of operations made it possible to hold consultations with virtually every sizeable vehicle manufacturer in the Western world -- a large number of parts makers in Canada and abroad, the interested trade unions, the provincial authorities with a significant share of the industry, foreign government representatives, interested Canadian government departments and agencies and a number of private individuals in Canada and abroad who had a special contribution to make.

A brief word about the broad nature of the report and its recommendations. When the government announced its decision to commission an inquiry, several criticisms were offered on the grounds that the subject had been studied to exhaustion and that what was needed was action — not more studies. Others, perhaps in a less serious vein, suggested that in choosing a Commissioner who had been intimately associated with the Canada-United States Automotive Product Trade Agreement of 1965 as the leader of the Canadian officials negotiating team, it was inviting a "whitewash" report. The Commissioner hopes to be forgiven if, having completed his report, he replies to these criticisms.

On the matter of whether the subject had been studied to exhaustion there are several substantive observations. The report will, it is hoped, establish that a number of widely held views by both interested and disinterested parties turn out, on investigation, to be based on incomplete information or on a woeful misinterpretation of the data available. This comment should not be interpreted as a complaint, because the hard fact is that certain basic statistical and factual information is simply not available or is available in a form which lends itself to serious misinterpretation. While the Commission does not claim to have resolved all the problems associated with the basic data, it offers certain fundamental additional information and clarifications which should help to illuminate the subject in a much more effective manner. Moreover, it is much more than a matter of understanding the issues which is at stake. It is a question of what to do about them. Where policy and operational decisions are involved, the stakes can be very high.

On the subject of whether the Commissioner, given his past association, may be committed to a particular strategy for the industry, he can only say that he has tried to maintain professional objectivity, and if human frailty makes that difficult, the quality of the people who assisted him in preparing this Report should certainly guarantee that any lingering prejudices would have been exposed and eradicated.

The Canada-United States Auto Pact is, of course, central to the condition and prospects for Canada's automotive industry. As such, its place in the scheme of things occupies considerable attention in the Report. It may be in order to acknowledge, in revisiting this subject a decade and a half later, that it comes as something of a shock to discover that a limited-purpose agreement, born of necessity, has come to be expected to solve every conceivable problem which existed, has arisen or may arise in the automotive industry. It has also become enshrined as an eternal religion. Whatever may have been its accomplishments, or failures, and it has its share of both as will be attested to in this Report, it can be said with confidence that it was never intended to be cast in concrete for all time. The need for revision to deal with changing circumstances has long passed. The need for policy adaptation to deal with issues that the Auto Pact did not even attempt to deal with has been apparent for some years. Whether this is a good time to re-open the Auto Pact or not is for governments to decide. Whatever the decision, there are a number of live issues affecting the automotive industry in Canada which demand attention within the framework of the Auto Pact or, if necessary, outside it.

A word of appreciation to the Commission staff. They were so few in number, so willing and able to take on whatever tasks came to hand, that it would be invidious to select among them for special comment. I can do no better than list them in alphabetical order and perhaps say who they are and what they did.

Douglas Arthur, Director General, Office of Special Import Policy, Department of Industry, Trade and Commerce, has the longest continuing contact with the auto industry of anyone in the government. His advice and counsel were invaluable throughout the Commission's work.

Bertram Barrow, retired Senior A.D.M., I.T. & C. and Chairman, F.I.R.A. A trusted and loyal colleague during more than thirty years of public service. Chief Lieutenant in the 1964 negotiation of the Auto Pact. His policy sense, inventiveness and solid good judgement contributed immeasurably to the Commission's work.

Gena Freeman, Secretary to an executive in I.T.C. Executive Assistant and Secretary to the Commissioner. Single-handed she looked after administrative and clerical needs of the Commission. Fast, competent and dedicated.

Keith Hay - Professor, Carleton and York Universities. Retained to do major drafting tasks and to advise on economic aspects of inquiry. He contributed fully to the completion of the Commission's responsibilities.

Paul Lau, Senior Industry Analyst, I.T. & C. A dedicated and indefatigable worker who almost alone handled the statistical tasks of the Commission. Of him it needs to be said that "he kept us honest" without fear or favour. His cheerful and positive outlook saw the Commission through some dark moments.

Loris Loewen, Economic Analyst, Department of Labour. A thoroughly professional economic analyst who carried the difficult task of productivity and labour market analysis for the Commission. In an area that knows no absolutes, her professional integrity helped the Commission avoid many traps and pitfalls.

Bruce MacDonald, Economic Communications consultant. An old campaigner in ancient wars through many budgets and several Finance Ministers, he was called the Commission scribe. He made major contributions to the drafting of large sections of the Report and helped to edit the balance. A solid, reliable and consistent performance without which it would not have been possible to meet the Commission's targets.

Andrei Sulzenko, Finance Officer, Department of Finance. The youngest and perhaps the brightest, he accompanied the Commission to Japan and Europe. An all-around officer, well trained in the social sciences, he contributed in every aspect of the Commission's work, consultations, research and analysis, drafting, critical review of policy proposals. The Canadian public service need not fear decline in its reputation and competence with men like him on the way.

It would be ungracious not to conclude this Preface with a word of heart-felt thanks to the many people who gave generously of their time, experience and wisdom in the preparation of this Report. Time and space do not permit a full statement of well-earned credits. These would include people in Canada and abroad from industry and business at

the very highest level, from government in both the public service and in politics, trade union leaders, professional and trade associations, as well as many private citizens.

In particular, the Commissioner appreciated the highly professional and realistic brief submitted by the United Auto Workers of Canada. This brief was most helpful in developing the Commission's proposals.

Finally, it needs to be said that while the ideas and recommendations included in this report have been garnered from many sources, the responsibility for its quality and validity of the recommendations must rest entirely with me.

A handwritten signature in dark ink, reading "Simon Reisman". The signature is written in a cursive, flowing style with a large initial 'S'.

S. Simon Reisman,
Commissioner.

C O M M I S S I O N

appointing

S. SIMON REISMAN

Commissioner under Part I of the
Inquiries Act to inquire into and
to report upon the means to ensure
the development in Canada of a
balanced and internationally
competitive automotive industry.

DATED 20th June, 1978

RECORDED 20th September, 1978

Film 432 Document 176

L. McLean

DEPUTY REGISTRAR GENERAL OF CANADA



James H. L. L.

Canada

ELIZABETH THE SECOND, by the Grace of
God of the United Kingdom, Canada and Her
other Realms and Territories QUEEN, Head of
the Commonwealth, Defender of the Faith.

James H. L. L.

DEPUTY ATTORNEY GENERAL

- X -

TO ALL TO WHOM these Presents shall come or whom
the same may in anyway concern,

GREETING:

WHEREAS pursuant to the provisions of Part I of
the Inquiries Act, chapter I-13 of the Revised Statutes of
Canada, 1970, His Excellency the Governor General in
Council, by Order in Council P.C. 1978-1996 of the
twentieth day of June in the year of Our Lord one thousand
nine hundred and seventy-eight, has authorized the
appointment of Our Commissioner therein and hereinafter
named to inquire into and to report upon the means to
ensure the development in Canada of a balanced and
internationally competitive automotive industry taking
into account:

- (a) the situation in, and structure of,
the Canadian automotive industry at the
present time, including the motor vehicle
manufacturers, the independent parts
producers and foreign vehicle manufacturers
participating in the Canadian market;
- (b) the factors affecting developments in the
industry and its future prospects including
the extent of foreign ownership, the
managerial aspects, the research and
development activity in Canada, the financial
resources requirements and availability, and

factors affecting the investment and employment pattern in the automotive industry in Canada;

- (c) the regional aspects of the Canadian automotive industry development;
- (d) relationships between the industry in Canada and the industry in the United States, including both those arrangements falling under the Canada/U.S. Automotive Products Agreement and those not covered by the agreement;
- (e) relationships between the industry in Canada and offshore producers; and
- (f) the Principles of International Business Conduct issued by the Government in July, 1975.

and has conferred certain rights, powers and privileges upon Our Commissioner as will be reference to the said Order more fully appear.

NOW KNOW YOU that, by and with the advice of Our Privy Council for Canada, We do by these Presents nominate, constitute and appoint S. Simon Reisman, Esquire, of the City of Ottawa, in the Province of Ontario, to be Our Commissioner to conduct such inquiry.

TO HAVE, HOLD, exercise and enjoy the said office, place and trust unto the said S. Simon Reisman, together with the rights, powers, privileges and emoluments unto the said office, place and trust of right and by law appertaining during Our Pleasure.

AND WE DO hereby authorize Our said Commissioner to consult as he deems appropriate with:

- (a) the motor vehicle manufacturers in Canada and the motor vehicle parts producers in Canada, including foreign-owned producers and representatives of offshore vehicle manufacturers participating in the Canadian market;
- (b) Canadian labour interests;
- (c) provincial government authorities;
- (d) foreign producers in the United States, Europe and Japan; and
- (e) foreign governments, through Canadian Government representatives abroad.

AND WE DO further authorize Our said Commissioner to obtain support to the fullest extent possible from departments and agencies of the Government of Canada in the conduct of the inquiry.

AND WE DO hereby require and direct Our said Commissioner to report his findings and recommendations to Our Governor in Council through the Minister of Industry, Trade and Commerce before October 31, 1978 and to file with the Privy Council Office the papers and records of the inquiry as soon as may reasonably be after the conclusion of the inquiry.

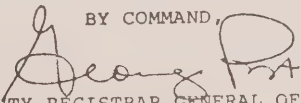
AND WE DO further direct that Our said Commissioner be styled the Special Adviser on the Canadian Automotive Industry.

IN TESTIMONY WHEREOF, We have caused these Our Letters to be made Patent and the Great Seal of Canada to be hereunto affixed.

WITNESS.

Our Right Trusty and Well-beloved Jules
Léger, Chancellor and Principal Companion
of Our Order of Canada, Chancellor and
Commander of Our Order of Military Merit
upon whom We have conferred Our Canadian
Forces' Decoration, Governor General and
Commander-in-Chief of Canada.

AT OUR GOVERNMENT HOUSE, in Our City of Ottawa, this
twentieth day of June in the year of Our Lord one thousand
nine hundred and seventy-eight and in the twenty-seventh
year of Our Reign.

BY COMMAND,

DEPUTY REGISTRAR GENERAL OF CANADA

CHAPTER 1

THE FIRST SIXTY YEARS

The Golden-Quarter Century

The essential shape and structure of the Canadian automotive industry was determined from its very beginning by the protectionist National Policy introduced 25 years before by the government of Sir John A. Macdonald.

In 1904, 117 Ford chassis were ferried across the river from Detroit to Windsor to be fitted with wheels and bodies by 17 employees of the Ford Motor Company of Canada, which was founded in that same year by a group of Canadian businessmen. As a direct result of the National Policy of 1879, there was created an indelible pattern under which U.S. affiliates established limited operations in the small Canadian market behind a high tariff wall and imported from the United States the many high-technology components that could only be built in this country at prohibitive cost.

When R.S. McLaughlin first designed and built a car of his own in 1908 at the McLaughlin Carriage Company in Oshawa, subsequently renamed the McLaughlin Motor Car Company, it might have seemed as if the Ford mold was not inevitable. But even McLaughlin relied heavily on many of the components and much of the technology that flowed from the mass U.S. market. "Recognizing the high cost of producing certain components in low volume, particularly the high cost of producing engines,

the McLaughlin Company entered into a contract to buy engines from the Buick Motor Company of Flint, Michigan, and was given access to all of Buick's development work," Prof. Vincent W. Bladen noted in his 1961 study of the auto industry.¹

In 1915, however, McLaughlin established the Chevrolet Motor Company of Canada to produce cars under agreement with the Chevrolet Company in the United States and, in 1918, both the McLaughlin and Chevrolet companies merged to become General Motors of Canada, Limited. The mold had become fixed.

Studebaker acquired production facilities at Walkerville, Ontario, in 1910, three years after McLaughlin had first begun turning out automobiles. International Harvester also began operations in Canada in the same year. The Chrysler Corporation of Canada was incorporated in 1925. The Nash Motor Company, predecessor of American Motors of Canada, came to this country in 1946.

During those early years, many Canadian entrepreneurs also sought to produce their own automobiles. "But the tariff protection of 35 per cent was not enough to protect an infant Canadian automotive industry," James G. Dykes, then General Manager of the Motor Vehicle Manufacturers' Association, pointed out in a 1975 paper.² "All who survived in Canada were allied to successful U.S. motor vehicle companies. It was the master mechanics of Detroit who developed the techniques of

¹ "Report of the Royal Commission on the Automotive Industry", April 1961, p. 5.

² "Background on the Canada-U.S. Automotive Products Trade Agreement", September, 1975; p. 3.

mass production for mass consumption which were necessary to make the automobile a practical, commercial and profitable product."

The fledgling Canadian automotive industry grew only slowly at first. Between 1904 and 1916, total production amounted to 135,000 vehicles. In 1910, 187,000 vehicles were produced in the United States alone, compared to 38,000 in France, 14,000 each in Britain and Germany, and 2,650 in Canada.

At the outbreak of the First World War in 1914, Canada produced 18,000 vehicles. By 1916, the total had climbed to 41,000 and in 1918 the figure had doubled to more than 80,000 in response to heavy wartime demands. Canada emerged from that conflict, as it was to emerge later from the Second World War, with an automotive industry considerably enlarged and strengthened.

Between 1918 and 1923, Canada was the second largest producer of motor vehicles in the world. More than 100,000 vehicles were produced for the first time in 1922. Production grew almost without interruption during the next seven years, reaching a peak in 1929 — one that would not be exceeded again in peace-time until 1947 — of 262,625.

Much of the driving force behind this phenomenal growth came from rapidly expanding exports to a number of countries abroad in which Canada enjoyed the advantage of the British Empire Preference. In 1923, total production amounted to 147,000 vehicles, of which 69,000 — 47 per cent — were sold abroad. In 1929, 102,000 vehicles were exported out of a total production of 265,000 or 39 per cent.

Throughout this period, exports of vehicles far exceeded imports. During the years 1921 to 1925, Canada enjoyed a favourable balance of

trade in cars and commercial vehicles averaging more than 38,000 annually and between 1926 and 1930 the surplus amounted to 35,000 vehicles annually. This was offset to some extent by annual average deficits in parts imports of \$11 million and \$32 million in the respective periods. Virtually all imports of vehicles and parts came from the United States.

As Prof. Bladen observed, the "achievement of this level of exports was made possible by the advantage which the Canadian automobile industry derived from the strength of its United States connection and by the preference which it enjoyed in certain Empire markets."³

By 1926, Canada's flourishing auto industry came face to face with another recurring imperative of national policy — the necessity of maintaining retail prices within politically acceptable limits in relation to those prevailing south of the border. In April of that year, Finance Minister James A. Robb declared in the House of Commons: "There is a pronounced sentiment throughout Canada that the automobile industry enjoys more protection than is needed to maintain it on a reasonably profitable basis, and in deference to that sentiment we propose a downward re-adjustment of automobile, motor truck, and motorcycle duties."

For cars valued at less than \$1,200, the British Preferential Tariff was reduced from 22½ per cent to 12½ per cent and to 15 per cent on cars valued at more than \$1,200. Since imports from British sources were negligible, these changes were of little consequence.

³ Bladen, Ibid., p. 7.

Far more important was the reduction in the General Tarriff rate, which then applied to the United States, from 35 per cent to 20 per cent on cars with a retail value under \$1,200, and to 27½ per cent for those which cost more than that amount.

Undoubtedly, the most important long-term aspect of the plan announced by the Minister of Finance was his proposal to integrate with the tariff reductions a Canadian content scheme. In one form or another, it has remained an essential element of automotive policy ever since. Then, as now, the basic objective was to reduce the cost of imported components and, hence, the price to the consumer, while at the same time encouraging the maintenance of a substantial degree of automotive production in Canada through an indirect but, nevertheless, very effective form of protection.

The content scheme initially unveiled by the government of the day provided for a drawback of 25 per cent of the duty otherwise owing on imported components provided that at least 50 per cent of the value of the completed vehicle was produced in the British Empire; effectively that meant Canada.

While motor vehicle production in Canada dropped by some 25,000 to 179,000 in the year following the implementation of the new tariff and content policy, it rebounded sharply to 242,000 in 1928 and, as previously noted, climbed to a peak of 263,000 in 1929, exceeding the respective outputs of Britain, France, Germany and Italy. The year 1929 also marked the end of the golden quarter-century experienced by the Canadian automotive industry since its inception in 1904.

The Depression Decade

In sharp contrast to European producers, who were far less geared to mass production for a mass consumption market, automotive producers in both Canada and the United States were hit severely by the onslaught of depression. In this country, production of vehicles tumbled steadily from 263,000 in 1929 to a low point of 61,000 in 1932 — less than a quarter of the 1929 level.

The plunge in production was matched by an equally serious reversal of the financial position of the automotive producers. In his background paper, James Dykes estimated that the industry's average profit per vehicle of nearly \$27 in 1929 was converted into a developing loss, which by 1932 reached a level of more than \$103 per vehicle.⁴ Production in the United States followed a similar pattern, plummeting from its peak of 5.3 million in 1929 to a low of 1.3 million in 1932. A substantial proportion of the decline in Canadian production was accounted for by a relatively more drastic decline in the export market, which fell from 102,000 in 1929 to 13,000 in 1932. Output began to recover slowly in succeeding years, climbing to 207,000 in 1937 before dropping again sharply in 1938 to 166,000.

Throughout the period from 1930 to 1936, the Federal Government introduced a series of measures in a desperate attempt to stem the tide.

⁴ Dykes, Ibid., p. 8.

In the first year, tariff rates were raised on a number of imported components and materials incorporated in the assembly of Canadian-made vehicles. Through an Order-in-Council in 1931, the government, in effect, increased values for duty on some imported cars. In the same year, the Customs' legislation was amended to increase the rate on cars imported under the General Tariff with a value of between \$1,200 and \$2,100 from $27\frac{1}{2}$ per cent to 30 per cent, and to establish a new rate of 40 per cent under the General Tariff for cars valued in excess of \$2,100./ A one per cent excise tax on the duty paid value of imported parts was also imposed in 1931 and increased to three per cent in 1932 as a means of providing further protection to the Canadian industry.

The Dykes' paper concluded that as a result of all these measures, "the importation of completely finished foreign cars dropped from 23 per cent of total sales in Canada averaged over the years 1929 and 1930 to $3\frac{1}{2}$ per cent averaged over the years 1931 to 1933, and three important automobile companies in the United States established plants in Canada; namely Hudson Motors, Graham-Paige and Packard."⁵

There were two other measures adopted by the government which were also to have an important impact. In 1931, Prime Minister R.B. Bennett announced that imports of all used automobiles would be prohibited because of growing importation of such vehicles — a prohibition that continues to the present day despite periodic complaints from the United States.

⁵ Dykes, Ibid., p. 8.

The following year the government made a curious reversal of its policy of increasing protection for the domestic automobile industry. Under a Canada-United Kingdom Trade Agreement, it granted duty-free entry to British vehicles without benefit of reciprocity. This concession was considered of little consequence at the time, but was destined to become a major factor in the Canadian market two decades later.

The successive moves by the government of the day to revive the ailing automotive industry through increased protection inevitably had the effect of widening the differential between Canadian and U.S. automobile prices. Over time, opposition began to gather force on two fronts. Canadian consumers, particularly those outside of Ontario who considered they received little or no benefit from the fruits of automotive production, grew increasingly resentful at the sharply higher costs of purchasing new cars in Canada compared to those prevailing in the United States. The resentment over the price differential was reinforced in the regions beyond Central Canada by the fear that moves by the government to protect secondary manufacturing generally were contributing to a world-wide movement toward protection, which had the effect of reducing or eliminating international markets for the primary products which they produced.

On March 13, 1935, Finance Minister E.N. Rhodes directed the Tariff Board to conduct the most comprehensive inquiry into the Canadian automotive industry ever undertaken since its beginning in 1904. In its report to the government on April 27, 1936, the Tariff

Board acknowledged the strength of the opposition to the high protective walls that had been erected to foster the Canadian industry, which by one estimate had contributed to the establishment of Canadian retail auto prices that were some 35 per cent above the U.S. level. During the hearings, the Board said, "grave doubts were expressed by a number of people ... as to the economic wisdom of maintaining and encouraging an automobile industry in Canada."

The Board calculated that as a result of the various measures of protection surrounding the industry, Canadians were required to pay a total of some \$14 million more in 1934 for the purchase of vehicles than if they had been able to import them duty-free. On the other hand, the Board estimated that domestic auto industry operations directly generated between \$40 million and \$47 million annually through payments for wages, materials, services, freight, taxes and other disbursements. On this basis, the members of the Board concluded "that it is 'good business' for Canada reasonably to encourage maintenance and expansion of the Canadian automotive industry."

It is not without significance that some months before the report of the Tariff Board was submitted to the Minister of Finance, the government entered into a trade agreement with the United States, effective January 1, 1936, which transferred U.S. imports from application of the General Tariff to that of the Intermediate Tariff, which later became designated as the Most Favoured Nation Tariff. In the case of automobiles, the effect of this agreement was to reduce the duty from 20 per cent to

17½ per cent on cars with a retail value of less than \$1,200, and to 25 per cent from 27½ per cent on cars valued at more than this amount.

The recommendations of the Board, which were implemented by the government on May 2, 1936, established a significantly revised duty and content system that was to remain in force essentially unchanged until the early 1960s.

Imports of British vehicles remained free of all duty. An across-the-board tariff of 17½ per cent was applied to all vehicles regardless of value under the Intermediate Tariff which, since it covered imports from the United States, was the most important change. Previously the duty was 25 per cent on vehicles valued at more than \$1,200 imported under this category. The General Tariff was set at 27½ per cent across-the-board. As a safeguard against the possibility that the revised Intermediate Tariff schedule could create undue hardships for the domestic auto industry, the government reserved the right to increase the rate to as much as 22½ per cent.

The content provisions first established in 1926, and subsequently substantially modified during the early "Thirties", were extensively revised under the new plan. The cumbersome system of domestic drawbacks of duty on imported parts and accessories was replaced by one providing for conditional free entry. The Commonwealth (actually Canadian) content requirement, however, was also increased from its previous level of 50 per cent to 60 per cent. As in 1926, the objective remained essentially unchanged: that of encouraging the greatest possible degree of automotive output in Canada consistent with the maintenance of price

differentials in relation to the United States that would be accepted — even if grudgingly — by the greater proportion of the Canadian citizenry.

A number of different categories for parts were established under the new tariff schedule and the manner in which each was treated varied significantly. A wide range of original equipment parts was allowed duty-free entry if it was of a class or kind not made in Canada, including such components as bearings, bushings and compressors.

A second category allowed duty-free entry of parts provided two conditions were met. They had to be of a class or kind not made in Canada. But, in addition, duty-free entry was conditional on the automotive companies achieving at least 40 per cent Commonwealth content if their production was less than 10,000 units per year, 50 per cent on production of between 10,000 and 20,000 vehicles, and 60 per cent in the case of companies producing more than 20,000 units. Parts in this category included axle housings, chassis, frames, cigarette lighters, horns and locks. In the event the two conditions were not met, the duty became $17\frac{1}{2}$ per cent under the Intermediate Tariff.

A third category applying to parts for commercial vehicles imposed the same two conditions, but the content requirement was only 40 per cent regardless of volume of production. A fourth main category covered a list of parts not provided for in other schedules, for which the Intermediate Tariff rate was 25 per cent.

The rationale of the revised tariff and content policy was succinctly put by Prof. Bladen in his own report on the auto industry a quarter-century later:

There are many parts, the cost of which in the United States, with its high volume of production, is so much lower than in Canada, with its much lower volume of production, that even high rates of duty would not suffice to induce Canadian automobile manufacturers to buy or produce them in Canada. If a duty were imposed, these parts would still be imported, the government would collect revenue, the Canadian consumer would pay more for his automobile, and the Canadian parts manufacturer might well find that the high prices of automobiles would reduce sales and, thus, reduce the demand for those parts which they could and did produce. Such is the logic of free entry if the parts are of a 'class or kind not made in Canada'. The content requirement offers an ingenious alternative to protection by duty. Without specifying what particular parts must be made in Canada, it requires that manufacturers incur in Canada a certain proportion of their factory cost of production. The manufacturer is left to discover what particular part of production should be undertaken in Canada if the additional cost imposed by the necessity of meeting the content requirement is to be reduced to the minimum.⁶

For three of the smaller producers, the content requirements proved to be an impossible handicap. Studebaker, Hudson Motors and Packard all ceased production in Canada shortly after the Tariff Board recommendations were put into effect. Because economic conditions

⁶ Bladen, Ibid., pp. 9 and 10.

remained unsettled through the remainder of the 1930's, it is not possible to judge the broader impact of the duty and content changes with any precision. In a subsequent period aimed at assessing the impact of its proposals on the industry, the Tariff Board estimated that Commonwealth content of the three largest manufacturers had increased from around 55 per cent in 1934 to more than 67 per cent in 1938. While new capital investment by vehicle manufacturers increased by \$19 million between 1934 and 1938, that of the parts producers rose by \$26 million during the years from 1936 to 1939.

Mobilizing for War

With the outbreak of the Second World War in 1939, the automotive industry girded itself for a massive expansion. A first order for gun carriers in the fall of that year was to be followed by other orders for hundreds of millions of dollars of military vehicles, equipment and armaments of almost every conceivable type. A total of 271,000 vehicles were produced in 1941 for military and civilian use. Passenger car production for civilian use was limited in 1941 and suspended in 1942. The following year, 216,000 military vehicles were turned out by the Canadian industry, which played a major part not only in equipping Canadian forces, but also in replacing British equipment lost at Dunkirk. While the volume of vehicle production declined after 1942, the rapidly expanding facilities of the industry were strained to their limits to meet demands for other military equipment and to provide parts for servicing existing equipment.

The Fortunes of Peace: 1945 - 1960

With the end of the war and the return of peace, the domestic auto industry faced very different circumstances than those confronting it during the latter part of the 1930s — some favourable, some unfavourable. On the one hand, it entered the period with a strong productive capacity both in terms of plant and of skilled manpower. The much expanded capacity of the Canadian economy itself held promise of strong domestic demand for its products. On the other hand, however, the industry faced the prospect of a severe contraction of its once huge export sales as a consequence of wartime disruption. Resulting controls imposed to conserve acute shortages of foreign exchange, together with the efforts of many overseas countries to develop automotive industries of their own behind high trade barriers, raised serious obstacles to Canadian exports.

Passenger car production resumed in September, 1945, and by 1948 production had climbed to 263,700, slightly exceeding the peak recorded in 1929. While production again expanded in 1949, exports declined and Canada experienced its first balance of trade deficit in vehicles — more than 9,000.

Under the impetus of strong domestic demand, automotive production in Canada continued for some years to grow by leaps and bounds. In 1950, output increased by an extraordinary 33 per cent to 390,000 and continued to climb steadily upward until 1953, when it reached a peak of 481,000 — a peak that would not be exceeded again until 1962.

Canadian production of vehicles declined drastically to 357,000 in 1953 and then rose over the 400,000 mark in the next three years. In 1958, however, production again dropped sharply to 360,000 and recovered only moderately in the next two years. During the same period, Canadian consumption of domestic and imported vehicles rose from 479,000 in 1953 to 553,000 in 1960.

The strong upward surge of imports from abroad was attributable to several factors. During the post-war period, a number of European countries adopted advanced technology and machinery to compete with North America in the mass production of vehicles for mass consumption. All of the European producers enjoyed the advantages of low wages and labour costs by comparison with North American standards. The post-war transformation of the British automotive industry also permitted it to capitalize on a further important advantage — that of exporting to the Canadian market duty-free as a result of the concession granted by the Canadian government in its agreement of 1932. Even the United States was not immune to this competition from abroad, and by 1957 had itself become a net importer of vehicles.

In the case of Canada, declining domestic automotive production and the rising tide of imported vehicles only served to compound already serious problems of slow growth and increasing unemployment confronting the nation in the late 1950s. The total deficit balance of trade in automotive products, which climbed to more than \$500 million in 1960, was a major contributor to Canada's current account deficit in that year of

\$1.2 billion. In the face of these developing adversities, the Federal Government on August 2, 1960, appointed Dr. Bladen, then a Professor of Economics and Dean of Arts and Science at the University of Toronto, as a one-man Royal Commission to undertake an extensive study of Canada's troubled automotive industry.

The Bladen Royal Commission -
An Important Turning Point

During the course of his inquiry, Dean Bladen received a number of proposals involving some form of integration of the Canadian and U.S. automotive industries. Ford of Canada suggested that integration of production, incorporating adequate safeguards through inter-company and inter-government agreements, could lead to a rationalization of the industry which would be of considerable benefit to Canadian consumers.

In a brief supported by the Canadian Labour Congress, the United Auto Workers recognized that the basic problem facing the automotive industry in Canada was the low volume of production, a problem that could "scarcely be dealt with by attempts to increase tariff protection." The UAW also put forward one of the most precise proposals for integration of the Canadian and United States industries. "In essence," the brief said, "we suggest that the Commission examine the feasibility of an international agreement which would permit free trade in the products of any motor vehicle manufacturing company provided that the company produced in Canada or had produced for it in Canada a quantity of motor vehicles and parts, sufficient to assure maintenance of current levels

of employment at current production volume and future increases in employment parallel with the growth of the company's Canadian market."

On the other hand, the Automotive Parts Manufacturers' Association contended that "the industry cannot survive without tariff protection." It proposed to replace the free entry under the British Preferential Tariff with a duty of $17\frac{1}{2}$ per cent and to increase the existing MFN rate applying to vehicles from the United States and most other producing countries from $17\frac{1}{2}$ per cent to 25 per cent. In addition, the Association proposed that in place of the existing $7\frac{1}{2}$ per cent excise tax a new 15 per cent tax be established which would be eliminated providing the manufacturers met certain Canadian content provisions according to the volume of output. For companies producing more than 30,000 units, the Canadian content proposed was 70 per cent in place of the existing 60 per cent.

In the report he presented to the government in April, 1961, Dean Bladen underlined the basic problems faced by the industry as a result of the production in low volume of a substantial number of different models and varieties at a time when the economies of scale were steadily increasing for many components. "The technology of the industry demands more and more expensive and specialized machinery. This requires ever increasing volumes of production before the full economies can be achieved." Furthermore, as he also pointed out, "the concept of optimum size is not a static one..."⁷

⁷ Bladen, Ibid., p. 26.

In framing proposals to deal with the problems of the industry he was asked to consider, Dean Bladen sought a middle ground. "My concern is to reconcile the interest of the consumer in low prices, that of the automotive producers in profits and employment, and that of producers of primary products in export markets," he asserted.⁸ He rejected proposals for unrestricted free trade because of the adverse impact it could have on a major Canadian industry unprepared to meet international competition. At the same time, however, he also rejected proposals for higher tariff protection urged by the parts manufacturers.

"An attempt to preserve the industry by imposing high duties would lead to a misallocation of resources and, indeed, it would be economically dangerous for the industry itself because, although the advocates of high protection seem to ignore this, high prices may lead to a contraction of the market."⁹

The Commissioner's report recommended removal of the existing $7\frac{1}{2}$ per cent excise tax, imposition of a 10 per cent rate of duty under the British Preferential Tariff, and changes in the formula for calculating the value for duty and sales taxes of vehicles to eliminate unfair discrimination against Canadian producers.

At the heart of Dean Bladen's recommendations, however, were far-reaching proposals for replacing the existing duty and content formula by a new "extended content" plan, which he saw as "the next logical step in the direction indicated by the Tariff Board in 1936."¹⁰

⁸ Bladen, Ibid., p. 47.

⁹ Ibid., p. 48.

¹⁰ Ibid., p. 78.

The report advocated that automobile manufacturers be permitted to import any vehicle and all parts — including those of a class or kind made in Canada and including replacement parts — free of duty providing they met revised Canadian (not Commonwealth) content requirements. It was proposed that Canadian content be calculated as a proportion of the total cost of manufacture of vehicles made in Canada, including the cost of imported components, together with the cost of imported vehicles and replacement parts. This new concept of the value of Canadian content as a proportion of the total was, therefore, not linked just to the cost of a completed vehicle produced in Canada, but also to sales by the manufacturer of vehicles and replacement parts imported from abroad.

The amount of Canadian content required to be achieved to obtain duty-free entry of vehicles and parts would vary under the scheme according to the volume of vehicles produced in Canada or imported. In the case of cars, it would range from a 30 per cent Canadian content on up to 5,000 units, to 50 per cent on the next 15,000 units, to 60 per cent on the next 30,000 units, and so on up to 75 per cent on units in excess of 200,000. Because of the incremental nature of the formula, the Canadian content of a manufacturer handling more than 200,000 cars would work out to just under 65 per cent. In the case of commercial vehicles, Bladen advocated a Canadian content starting at 30 per cent for up to 5,000 vehicles and working up to a maximum of 60 per cent for more than 50,000 vehicles.

The Commission calculated that the average Canadian content in the output of the Big Three — General Motors, Ford and Chrysler — was around 65 per cent at the time of his report. He estimated that under his plan, GM would be required to maintain approximately its existing content proportion, but that of Ford would be around 60 per cent and Chrysler's 55 per cent. He also estimated that his extended content plan would have resulted in a 10 per cent increase in auto production in 1959, a total of some 30,000 vehicles worth \$60 million. At the same time, the effect of the removal of the excise tax, the change in the wholesale base for sales tax calculation and elimination of duties, would have resulted in prices being reduced on the average automobile by between \$180 and \$240. In sum, he saw his plan as "an effective method of protection which is expansionist rather than restrictive."

In the budget that followed in June, 1961, the government accepted the Commissioner's recommendation on the removal of the excise tax and the change in the valuation basis for sales tax purposes, which he considered discriminated against domestic producers. However, it reserved for further consideration and discussion the main body of his proposals.

While the reaction was generally favourable, it was not unanimously so. The Automotive Parts Manufacturers' Association condemned the new content scheme as "disastrous". Harry Johnson, a Canadian-born economist with international academic roots, savaged it as fundamentally a protectionist scheme which, among other things, would have the effect

of subsidizing exports. Karl E. Scott, President of the Ford Motor Company of Canada, welcomed the proposal as a practical means of implementing the kind of integration that his company had advocated in its submission to the Bladen Inquiry. However, he also saw a cloud on the horizon — namely, the possibility that the United States might invoke countervailing duties.

In the months that followed release of the Bladen Report, it became clear that the tide of imported cars from overseas had passed its peak and was rapidly receding. Canada, however, continued to face growing problems with respect to the current account of its balance of payments, some of them resulting from the growing inflow of auto parts. The value of the Canadian dollar had declined from a premium in U.S. funds to a discounted rate of $92\frac{1}{2}$ cents and was again re-pegged under the International Monetary Fund after floating freely for a decade. In June of 1962 a 10 per cent surcharge was imposed on import duties, which — together with the introduction of small North American built cars — hastened the ebbing tide of overseas imports.

Nevertheless, the underlying problem confronting the Canadian automotive industry remained unchanged — that of a low volume production of many different types of vehicles and components at a time when the onrush of technology was putting an increasing premium on high volume output.

The nature of the problem was well illustrated in the case of transmissions. During the years when the "standard" transmission was, in fact, just that, Canada could produce the manually-shifted models required for assembly in Canadian-made vehicles at reasonably economic cost.

The situation was altered drastically, however, with the development of the automatic transmission, which quickly began to displace what subsequently came to be known as the standard transmission. In his report, Dean Bladen said that he had learned during the course of his investigation that a highly capital intensive plant built to produce automatic transmissions required an output of around 400,000 units a year to realize its optimum efficiency. Only some 230,000 vehicles produced in Canada in 1960 — 60 per cent of the total — came equipped with automatic transmissions. On that basis, he pointed out, it would not have been economical to maintain a plant to produce them for the Canadian market even if all models could employ one basic transmission — which, of course, they could not.

In October, 1962, Finance Minister George Nowlan introduced a scheme relating primarily to automatic transmissions which represented a first step toward introduction of the concept advanced in the Bladen Report. For a previous period of 10 years, an Order-in-Council had regularly waived the 25 per cent duty otherwise payable on transmissions imported from abroad. The government had, however, applied a similar rate of duty on imported engine blocks. Under the plan adopted by the government, the 25 per cent duty on automatic transmissions would henceforth be collected. But manufacturers could recoup the duty on the transmission, and that on up to 10,000 engine blocks, on a dollar-for-dollar basis, to the extent they increased exports of Canadian-made parts over the level in the base year — November 1, 1961, to October 31, 1962.

While the U.S. reaction to the first-stage plan was not enthusiastic, neither was it excessively hostile. In October, 1963, Industry Minister C.M. Drury announced that the new Liberal government which had taken office during the spring of 1963 had approved an Order-in-Council adopting a full duty-remission system for an initial period of three years.

Under this second-stage plan, a Canadian manufacturer could earn remission of the duty owing on any imported vehicles or original equipment parts, on a dollar-for-dollar basis, to the extent he increased the Canadian content in either vehicles or parts exported over and above the level in the base year established under the first-stage plan. Eligible parts exports included those produced by independent manufacturers as well as those produced by the auto manufacturers. Mr. Drury estimated that if full advantage were taken of the plan by the industry, Canadian automotive-related exports would increase by \$150 million to \$200 million, with an equivalent remission on import duties. The objective of the plan was three-fold: an increase in output and employment; a reduction in the automotive trade deficit; and provision of an opportunity for Canadian producers to gain access to markets which would permit increased specialization, longer production runs and lower costs.

Spokesmen for the Canadian government insisted that the expanded auto plan was consistent with Canada's commitments under the General Agreement on Tariffs and Trade, and that it was not in any way restrictive, but rather expansionary in nature. On both sides of the border, the objectives of the plan — if not the plan itself — received significant support from industry and labour. The U.S. government was sympathetic

with regard to Canada's overall balance of payments problems and there were even suggestions from some quarters in the Administration that the two countries should be thinking about moving toward free trade in automotive products.

The main source of dissent south of the border was among independent U.S. parts producers and the avenue open to them to express their dissent was the U.S. Customs Act of 1930. Section 303 of that statute provides that if the Treasury Department determined that the export of a certain product to the United States was being subsidized through a "bounty or grant", it was required to impose a countervailing duty regardless of whether or not it caused damage to the domestic industry.

While the Administration itself had authority to launch an action under the provisions of the Act, it chose not to do so. The government's hand was forced, however, by a petition filed on April 15, 1964, by the Modine Manufacturing Company of Racine, Wisconsin, with the U.S. Bureau of Customs, which charged that the Canadian remission plan constituted a "bounty or grant" under the 1930 Act. Faced with this petition from the radiator manufacturing company, which was morally supported by some 15 other parts producers and some influential U.S. senators, the Bureau of Customs in the Treasury Department had no choice but to set the wheels in motion for a formal review of the Canadian remission plan.

What the outcome of that review would have been if it had been allowed to move to its conclusion will probably remain forever unknown. What is well known is that the Canadian and U.S. governments were sufficiently concerned about the possibility of an

adverse ruling, which could have seriously damaged the trade and political relations of both countries, that they set about urgently to find a solution in an effort to forestall just such a result.

The scheme that finally evolved several months later after a period of intensive negotiation was to mark a sharp turning point in the history of the automotive industry from the time of its founding 60 years before. In a sense, however, it was also part of an evolutionary process stemming back to the Canadian content scheme of 1926, which represented the first of a series of attempts to reconcile a protective national policy with the necessity for Canada to keep pace with an increasingly competitive world.

CHAPTER 2

THE AUTOMOTIVE INDUSTRY UNDER THE PACT

The threat of countervailing duties acted as a sharp spur to the governments of Canada and the United States to seek an alternative framework for trade in automotive products that was mutually acceptable. During the course of the next several months following the filing of the Modine petition in April, 1964, Canadian and U.S. officials embarked on an intensive series of discussions, both among themselves and with representatives of the various sectors of their respective industries. The results were embodied in the Canada-United States Automotive Products Trade Agreement signed by Prime Minister Lester Pearson and President Lyndon Johnson at the President's ranch at Johnson City, Texas, on January 16, 1965. On that same day, Canada moved to implement the Agreement through two Orders-in-Council. Enabling legislation was subsequently adopted by Congress in October, 1965.

Provisions of the Pact

Essentially the Agreement provided for free trade between the two countries in original equipment parts and in all but specialized types of newly manufactured vehicles. It excluded trade in aftermarket parts and accessories, tires and tubes, batteries and used vehicles. Duty-free

entry of those vehicles and parts covered by the Agreement was, however, governed by a number of specific conditions, most particularly with respect to imports into Canada. Three of the latter conditions were included in the bilateral agreement itself and two additional conditions were incorporated in Canada's implementing Orders-in-Council, which grew out of undertakings made by the motor vehicle manufacturers in Letters of Agreement with the Canadian government.

For its part, the United States restricted duty-free entry to original equipment parts and vehicles from Canada, which required it subsequently to seek a waiver under the General Agreement on Tariffs and Trade because of the departure from the most-favoured-nation principle of GATT. The only proviso imposed by the United States on free entry of automotive products from Canada was that at least 50 per cent of the content value be of North American origin. That condition aside, the right of duty-free entry into the United States by either an individual or a company was unqualified.

The five different conditions governing duty-free entry into Canada, which came to be termed safeguards, were intended to help overcome the institutional barriers faced by Canadian industry in the newly integrated North American market.

The Agreement stipulated as a first condition that only a Canadian manufacturer of cars or commercial vehicles could import products duty-free. Unlike the United States, Canada permitted free entry from any country — providing the conditions were met and, thus, came within the provisions of GATT.

To qualify as a "manufacturer", however, a company had to have produced vehicles of a particular class — such as, automobiles, trucks or buses — throughout the base year, which was August 1, 1963, to July 31, 1964, and to have produced vehicles in that class during the 12-month period to July 31 in which vehicles and/or original equipment parts were imported. Later entrants who met the necessary conditions were designated as manufacturers by Orders-in-Council.

In addition, a manufacturer was required to meet two other conditions:

1. That the ratio of the net sales value of any class of vehicle produced in Canada to the net sales value of vehicles of that same class sold in Canada remain equal to the ratio between production and sales prevailing in the base year or at least amount to 75 per cent, whichever is the higher.
2. That the amount of Canadian content in each class of vehicle produced in Canada — what was termed "in-vehicle" Canadian value added (CVA) — be at least as great in absolute terms as the Canadian value added in the base year.

The ratio provision was aimed at maintaining the proportion of vehicles assembled in Canada in relation to vehicles in each class sold in Canada. It was framed particularly to meet the concerns of the United Automobile Workers and the independent parts producers. The former saw the assembly ratio as a means of ensuring the maintenance and expansion

of employment in the assembly sector of the industry, while the latter regarded it as a means of ensuring the maintenance and expansion of demand from Canadian motor vehicle manufacturers for the parts which they produced. The independent parts producers, at least, have come to regard this provision in quite a different light in subsequent years.

The next condition, which provided a floor under the amount of Canadian value to be added in absolute terms, was established as a further measure of support for Canadian parts producers.

In the Letters of Agreement, the motor vehicle manufacturers entered into two other commitments. They undertook to ensure that in each model year the value added in Canada would amount to at least 60 per cent of the growth of the value of cars sold in Canada and by at least 50 per cent of the growth in the value of commercial vehicles sold in Canada. Over and above that provision, Canadian vehicle manufacturers collectively agreed to increase the amount of CVA being produced in Canada as of the model year beginning in August, 1967, by a further \$260 million annually.

As a result of the substantial growth in Canadian value added that followed the implementation of the Agreement, the Canadian manufacturers collectively more than met the \$260 million requirement. The "in-vehicle" CVA condition in the Agreement was also soon met. The assembly ratio provision in the bilateral agreement and the CVA-to-sales ratio provided for in the Letters of Agreement continue to have an effect on levels of overall automotive production in Canada.

The Agreement between Canada and the United States was unlimited in duration, but Article VII stipulated that it could be terminated on a year's notice by either country. It also stipulated that by January 1, 1968, the two governments undertake a comprehensive review of the progress being made toward achievement of the Agreement's objectives in order to consider any further steps that should be taken in pursuit of that goal.

The objectives of the Agreement set out in Article I were three-fold:

1. The creation of a broader market for automotive products within which the full benefits of specialization and large-scale production can be achieved;
2. The liberalization of United States and Canadian automotive trade in respect of tariff barriers and other factors tending to impede it, with a view to enabling the industries of both countries to participate on a fair and equitable basis in the expanding total market of the two countries; and
3. The development of conditions in which market forces may operate effectively to attain the most economic pattern of investment, production and trade.

It shall be the policy of each government to avoid actions which would frustrate the achievement of these objectives.

The Rocky Road from Johnson City

From the time of its signing, the Automotive Agreement between the two countries has been a continuing source of controversy on both sides of the border despite the generally acknowledged benefits it created for both Canada and the United States.

In part, the controversy has arisen because of differing perceptions of the Agreement's objectives and provisions, differing views as to its intended impact on each country, and differing interpretations of actual results.

The studied ambiguity of the Agreement's stated objectives reflected basic differences in emphasis of each government. U.S. representatives recognized the validity of Canada's contention that some safeguards were required to enable the relatively small and fragile Canadian automotive industry to adjust to competition against their giant U.S. counterparts in a North American market. But they contended that the safeguards should be in place for a limited time only, describing them from the outset as "transitional". At the end of this so-called transitional period, patterns of investment, production and trade should be determined by "market forces".

Canada's preoccupation, however, was reflected in the clause advocating the liberalization of automotive trade so as to enable the industries of both countries "to participate on a fair and equitable basis" in an expanding North American market.

Canada's preoccupation reflected a deep concern that in a highly oligoplistic North American automotive industry totally dominated through ownership and control by a handful of giant U.S. companies, there were a great many "institutional barriers" which could seriously impair the working of "market forces" and preclude an opportunity for Canadian companies to participate on a fair and equitable basis.

During the course of the negotiations, Canadian representatives continued to resist U.S. pressure to provide a terminal date for the safeguards protecting its domestic industry. While they indicated they would be prepared to consider doing so during the course of the 1968 review provided for in the Agreement, they did not commit themselves to such an undertaking, as a result that nothing in the Pact stipulates that they are of a transitional nature — contrary to repeated allegations to this effect by U.S. spokesmen. On the Canadian side, the clause written into the Agreement that was intended to ensure that institutional barriers should not operate to prevent this country from having the opportunity to compete in the continental market on a fair and equitable basis, has progressively come to be interpreted as meaning that under the Pact Canada was "guaranteed" a "fair share" of output, employment and investment in relation to Canada's share of the North American vehicle market, which is equally unsupported by the facts.

In a press release issued just prior to the signing of the Agreement, Industry Minister C.M. Drury said it was necessary to introduce "special features" because even with the removal of the tariff and other governmental barriers, there were other factors that would make it

difficult for the Canadian industry to compete on a fair and equitable basis. He included among them "differences in size and financial strength of the respective industries of Canada and the United States, the pattern of ownership and control, the deeply imbedded habits and customs prevailing in the industry and the many other institutional impediments to trade..."

In considering during the 1968 review whether the safeguard should be removed, the Minister said; "Canada will wish to be assured that institutional barriers now limiting Canadian production and trade have been eliminated or substantially reduced and that the initial program has gathered sufficient momentum to ensure that market forces, unaided, will provide adequately for the situation after 1968. The test will be whether the Canadian automotive industries have adequate opportunity to participate fully and equitably in the expanding North American market."

Mr. Drury noted that at the time of the signing of the Agreement, Canada produced some 4 per cent of North American automotive output, but consumed around 7.5 per cent. "As a result of the program, Canada should be producing a substantially larger share of total North American output by the time vehicles for the 1968 model year are on the road," he said. He expressed confidence that the Agreement would also "help to achieve the government's objective of reducing Canada's current account deficit" in automotive trade with the United States, which was then running around \$600 million a year in 1964. In addition to the increase in output and employment and the decline in the deficit, Mr. Drury also expressed confidence the Pact would lead to the gradual

reduction in the differential between motor vehicle prices in Canada and the United States.

In Canada, the Automotive Agreement was generally received as a step that held some promise for the future, although there was criticism of some of its particular provisions and concern about the dislocations that might be created within the industry as an outcome of the adjustment process. In part the latter concern was met by the decision in the summer of 1965 to create an Adjustment Assistance Board under the chairmanship of Dean Bladen to help smooth the transition for both workers and parts manufacturers. But the Pact as a whole was condemned outright by the Progressive Conservative Party. Speaking in the House of Commons on behalf of his party during a two-day debate on a resolution in May, 1966, seeking Parliament's concurrence in the Agreement, A.D. Hales, the Member for Wellington South, contended that Canada had sold its "economic birthright", the consequences of which would inevitably be the sale of its "political birthright."

In putting implementing legislation before Congress, President Johnson said the Agreement had been worked out in the face of "the prospect of a wasteful contest of stroke and counterstroke, harmful to both Canada and the United States, and helpful to neither".

While the legislation was eventually approved by Congress, it received a mixed reception, particularly in view of the outspoken criticism of a handful of influential senators from states where there was a significant concentration of independent U.S. parts producers.

"...The Congress resented being asked to ratify what it regarded as a fait accompli, in violation of what it considered to be its constitutional prerogatives in setting U.S. trade policy," recalled Carl E. Beigie. "It was displeased also with the letters of undertaking, in terms of both their contents and the method of procurement by Canada. While there were some advocates of the Agreement in the United States who saw positive benefits arising from it, others saw the main benefit in negative terms: preventing a trade war with a major economic and political ally. Some U.S. criticisms felt the whole affair suggested blackmail by Canada."¹

In both Canada and the United States, an important consideration was the impact that the Agreement would have on the automotive trade balance. The likely outcome was viewed quite differently on the two sides of the border. As already noted, the Canadian government considered that it would result in a significant reduction in Canada's trade deficit with the United States. But the Johnson Administration took the position before Congress that the United States would continue to maintain its net surplus to 1968 at around the level pertaining in 1963-64 — or approximately \$495 million to \$580 million.

¹ Canadian American Committee; "The Canada-U.S. Automotive Agreement: An Evaluation", 1970; p. 52.

Mileposts Along the Way

During the years immediately prior to the signing of the Agreement, Canada's automotive output was considerably below its consumption, its automotive trade deficit was already large and growing deficits were indicated for the future. Productivity was estimated at some 60 to 65 per cent of the U.S. and was in danger of slipping further behind as a result of significant advances by U.S. and overseas producers with access to mass markets, and wages were only some 70 per cent of the U.S. level.

The early years of the Agreement produced substantial increases in output, employment, investment and productivity in the automotive industry in Canada, a substantial growth in exports and imports as a result of the rapid move to specialization, and a slow but steady decline in the price differential for cars at the factory level. But manufacturers complained that their ability to compete with their American counterparts was impaired by the 11 per cent sales tax on production machinery and equipment, which the government moved to eliminate in June of 1967. As a result of the Kennedy Round of negotiations under the GATT, the Canadian MFN tariff on automobiles was reduced from 17½ to 15 per cent in that same month. The Federal Government also took steps to establish a board to determine whether or not machinery was available in Canada at reasonable cost and within a reasonable period of time. In the event that it was not, the 15 per cent duty on imported machinery would be waived, which provided a further measure of assistance to vehicle and parts manufacturers in Canada.

In July of 1967, the UAW headed into collective bargaining with the motor vehicle manufacturers in the United States, with one of the union's primary demands being the establishment of wage parity for Canadian automotive workers. Eventually the industry agreed to bring Canadian wages to U.S. levels over a $2\frac{1}{2}$ year period. The gradual closing of the existing wage gap of some 30 per cent, which had been a factor in helping the Canadian industry to reduce the handicap of substantially lower productivity, was a development that had important implications for the future.

As noted earlier, the trade balance was regarded in both Canada and the United States as one of the main indicators of the relative position of each country. Although the United States continued to enjoy a large surplus, by 1966 the balance was beginning to move slowly in Canada's favour. That such a shift was taking place seemed apparent, but the extent of the change remained shrouded in doubt as a result of steadily growing disparities between Canadian and U.S. automotive trade figures. The following year, the U.S. Bureau of the Census reported that the United States had a deficit of \$159 million, while Statistics Canada reported a U.S. surplus of \$382 million — a difference of \$541 million. By 1970, the Census Bureau was estimating the U.S. deficit had risen to \$972 million, well above the levels recorded by Statistics Canada.

In Canada, the reversal of the trend in the automotive trade balance was welcome news and seen by the government as concrete evidence of the benefits of the Pact for this country. It was, of course,

regarded in the very opposite light south of the border. In mid-1968, Sen. Albert Gore of Tennessee and Sen. Vance Hartke of Indiana induced the Senate Finance Committee to conduct a special hearing, during which they pressed unsuccessfully for termination of the Agreement.

Meanwhile, the bilateral review of the Automotive Agreement which was begun in December, 1967, in keeping with its provisions, was proceeding to completion — but to no resolution of the various issues.

In a press release issued on August 30, 1968, Industry, Trade and Commerce Minister Jean-Luc Pepin announced that the review consultations had been "successfully completed". The release outlined the substantial progress that had been made in increasing Canadian output, employment and productivity, together with an appreciable narrowing of the price differential for automobiles. "During the review", it continued, "consideration was given to possible means of progressing toward the full achievement of the agreed objectives. Considerable progress has been achieved already in agreeing on steps to further simplify customs and other administrative practices and this matter is being actively pursued. Both sides indicated an interest in exploring ways of broadening the Agreement to the benefit of each country. Discussions to this end will be continued when the United States Administration is in a position to recommend the necessary legislation to Congress."

The commitments which the Canadian manufacturers had given to the Federal Government prior to the signing of the Agreement in 1965 had been a continuing source of friction with the United States. The press

release issued by the Minister of Industry, Trade and Commerce disclosed for the first time that further letters had been received from Canadian vehicle manufacturers.

In a special report to Congress on September 4, 1968, President Johnson indicated that no decision had been reached with regard to changes in the Agreement as a result of the bilateral review of its provisions. "During the review," he said, "four general areas were considered as possible means of progressing further toward full achievement of the Agreement's objectives. These were (a) liberalization of conditions on duty-free entry into Canada; (b) possible amendment to the Agreement to encompass additional products; (c) simplification of customs and other administrative practices; and (d) improvement of reconciliation of trade statistics."

The President also assured Congress that no additional undertakings to increase Canadian content had been given to Ottawa by Canadian manufacturers. Copies of the letters from the companies referred to by Mr. Pepin in his press release were subsequently tabled in the House of Commons on September 16, 1968. They indicated the aspirations of the firms for continued expansion in output, but the companies did not commit themselves to any given target in quantifiable terms.

The statement by Mr. Pepin suggested that discussions on broadening the coverage of the Agreement would be resumed when the U.S. Administration "was in a position to recommend the necessary legislation to Congress". The fact of the matter, however, was that the U.S.

Administration was not prepared to reopen the issue in Congress unless and until Canada had agreed to abandon the remaining safeguards protecting the Canadian automotive industry, which it adamantly refused to do. Since a considerable body of opinion in both the Senate and the House of Representatives was convinced that the deterioration in the U.S. trade position was a direct result of these safeguards, the Administration judged that Congress would be in no mood to contemplate enlargement of the Agreement to cover additional areas so long as the Canadian safeguards remained in place.

In November, 1969, further discussions were scheduled to be held between officials of the two countries, during which the United States would again press for abandonment of the safeguards. The Canadian government's continued opposition to such a move was made clear beforehand by Mr. Pepin in a speech to the Canadian Automotive Parts Manufacturers' Association on October 23, 1969:

As you are aware, we will again very shortly be discussing the Agreement with the U.S. Government. Our neighbours seem to think that Canada has done a little too well out of the Agreement. We in Canada take the view that we have still a long way to go before we have — as indicated in the second objective of the Agreement — a fair and equitable share of the total North American market for automotive products. It will be important to try and bridge this difference of approach during the forthcoming discussions.

That the government's view reflected strongly held opinion north of the border was evident from an editorial in The Globe and Mail on November 13, 1969. "As long as the Canadian-produced share of (the North American) market remains considerably below our consumption, the Canadian negotiators have a strong case to demand that our interests be protected," the paper asserted.

During the discussions that followed later that month, representatives of the two governments could do no more than agree to disagree on this underlying issue. One concrete outcome, however, was the decision to establish a sub-committee to seek ways of reconciling the growing disparity between the automotive trade figures of the two countries. In order to overcome this problem, both countries agreed that a more accurate and reliable picture of the trade position would be provided by employing the import statistics of each country to also provide the basis for determining the exports of the other. On this reconciled basis, the figures indicated that the United States continued to enjoy an automotive merchandise trade surplus, although one that was rapidly declining, to 1969. By 1970, the reconciled figures showed that the United States had a deficit of U.S. \$196 million and of virtually the same amount again in 1971. In each of those two years the Bureau of the Census figures recorded a deficit exceeding U.S. \$1.25 billion.

The year 1970 was also notable for other developments. Parity of wages on a nominal dollar basis came fully into effect. Total automobile sales in Canada in that year declined sharply, partly because of

a major work stoppage in the industry. At the same time, overseas imports -- particularly those from Japan -- increased by 20,000 over the previous year to a total of 143,000. As a result, the share of the market of cars from third countries rose from 16 per cent in 1969 to 22 per cent in 1970. A similar trend was also evident in the United States, but the decline in total sales was somewhat more moderate and the increase in third country imports still left their share at only 14 per cent. During 1970 also the Senate Finance Committee appended a direction to a bill before it requiring the President "to take whatever action is necessary to assure that complete freedom of trade in automobiles between Canada and the United States is achieved by January 1, 1973." Although that bill was never passed, President Richard Nixon's Annual Report to Congress on the Agreement in 1970 was also critical of the Canadian safeguards. "Retention of these measures as permanent features of the Agreement," the report said, "would be contrary to the premise on which the U.S. entered the Agreement, namely that market forces would be allowed to determine the most economic pattern of investment, production and trade."

During 1971, a measure of understanding was reached between the two countries under which changes were made through regulations to include certain off-highway vehicles in the provisions of the Agreement. Canada also agreed to extend duty-free treatment to snowmobiles, which as a result of an anomaly were included under the Pact by the United States, but not by Canada. This became a particular source of irritation when rapidly increasing exports of Canadian snowmobiles to the United States

was becoming a principal contributor to Canada's automotive trade surplus.

In mid-August of 1971, President Nixon announced a wide-ranging series of measures aimed both at reversing the United States' mounting current account deficit with other nations and checking the spiral of domestic inflation. For Canada, the U.S. program had both adverse and beneficial implications.

The imposition of a 6½ per cent surcharge on the duty imposed on imported vehicles from overseas and the removal of the U.S. 7 per cent excise tax provided a measure of protection and a stimulus to sales that together tended to promote Canadian automotive exports to the United States. The subsequent appreciation of the currencies of North America's major trading partners in response to U.S. pressure also worked to reinforce the competitive position of Canadian and U.S. automotive producers in the North American market. On the other hand, the incentives extended to U.S. companies through the Job Development Act and the Domestic International Sales Corporation system threatened to work against new automotive investment in Canada. At the same time, the Nixon Administration applied increasing pressure on Canada to remove the safeguards, which by then it was describing as the principal "irritant" in U.S.-Canadian relations. In February, 1972, John Connally, the U.S. Secretary of the Treasury, issued a report which singled out Canada as the only country with which the United States had not been able to reach a satisfactory agreement as part of the U.S. effort to bring about a substantial improvement in its balance of payments position.

The Canadian Government refused to yield ground on the safeguards, however, and in the budget of May, 1972, Finance Minister John Turner proposed reduction in corporate tax rates on Canadian manufacturing companies and depreciation of their investment in machinery and equipment over a two-year period, which more than balanced the investment incentives established in the United States.

By 1972, Canada's automotive trade surplus with the United States had declined to Cdn. \$44 million from \$198 million the year before. By 1973, the surplus of the previous year had been converted into a deficit of \$428 million, which by 1975 had increased to \$1.9 billion before receding to around the billion dollar level in 1976 and 1977.

While this change in the balance of automotive trade between the two countries served to ease some of the pressure from the U.S. for removal of the safeguards, they continued to be a bone of contention. In July, 1975, the Senate Finance Committee requested the United States International Trade Commission to study and report on the operations of the Auto Agreement and, in particular, to express its views "as to whether or not Canada has fully complied with the letter and spirit of the Agreement by phasing out the so-called 'transitional provisions'." In January the following year, the Commission expressed its opinion that Canada had not fully complied with the Agreement.

The report said that this country had "used conditional duty-free treatment as an incentive to maintain certain levels of production in Canada as it did prior to the Agreement, and it seems likely that Canada would continue this policy in the future even if the Agreement were terminated." When the Agreement was examined in its totality, the Commission continued, "it is manifest that the only concessions granted in the Agreement are those granted by the Government of the United States according duty-free treatment to imports of automotive products manufactured in Canada."

In a dissenting opinion, however, Commissioner Italo H. Ablondi rejected the suggestion that the shifting balance of trade between Canada and the United States was affected by the Canadian safeguards.

In my view the relative structures of production within the United States and Canadian markets are governed by decisions made in the corporate offices in Detroit, which are based on the best interests of the multinational corporations irrespective of United States or Canadian national interests. The corporate multinationals are the main force that control the economic pattern of investment, production and trade in United States-Canadian motor vehicle production. These decisions ... are usually made with the ultimate objective of maximum profit and rationalization of production, and have resulted in production, trade and investment patterns not envisioned by either the Government of the United States or the Government of Canada in 1965, despite the conditions of Annex A and the "letters of undertaking".

About the same time as the Senate Finance Committee requested the Commission to undertake its inquiry, the U.S. Treasury Department launched a series of inquiries as a result of allegations that motor vehicles from a number of countries were being dumped in the United States at less than their fair market value. In May, 1976, the Treasury Department gave notice that it was tentatively discontinuing its investigation of dumping allegations relating to Canada on the condition that commitments were forthcoming from the manufacturers to move toward elimination of differences between Canadian prices in the United States and in their own domestic market.

In 1977, reports were issued by task forces established in both Canada and the United States following an agreement between President Gerald Ford and Prime Minister Pierre Trudeau that each country should undertake "separate but parallel studies of the impact of environmental, energy, and safety regulations and emerging market factors upon the respective sectors of the North American automotive industry." By design, both studies avoided any discussion of issues relating directly to the Automotive Agreement, although the review undertaken by the task force in this country provided a comprehensive profile of the Canadian auto industry and pin-pointed a number of factors and forces affecting it. The position of the industry was also examined earlier this year in the report by the Automotive Consultative Task Force established by the Minister of Industry, Trade and Commerce, and in a section of the second volume of the report by the Standing Senate Committee on Foreign Affairs on Canada's Trade Relations with the United States.

In Canada, dissatisfaction with the Automotive Agreement has grown in direct proportion to the increase in the Canadian trade deficit in automotive products. There have been mounting complaints from many quarters that Canada was not obtaining its "fair share" of automotive output generally, parts production, investment, employment or research and development in relation to the market it provided for North American vehicles.

In attempting to deal with the contentious issues relating to automotive trade between the two countries that arise out of the checkered course of developments over the past decade and a half, and the perceptions and misconceptions relating to those developments, it is essential as a first step to try to separate reality from supposition. Up to this point, the discussion has focussed largely on the position of the Canadian automotive industry as it related to the North American market. But the present and prospective position of the Canadian automotive industry can only be viewed in perspective within a global framework. If we are to come to grips with the issues that confront us, then it is imperative to first understand their real nature.

CHAPTER 3

Factors and Forces Affecting the Canadian Automotive Industry

The Pattern of Trade

The flow of trade between Canada and other countries has long been one of the principal yardsticks adopted by governments and the public as a measure of the health of the automotive industry and its competitiveness with the rest of the world.

The trade statistics which provide that yardstick are drawn together in ways that follow internationally accepted economic theory and statistical practice. In fact, however, the statistics have come increasingly to conceal more than they reveal about the real patterns of automotive trade between Canada and other countries - including the United States.

In 1970, the Canadian and U.S. governments decided to reconcile the increasing disparity of their trade figures by adopting the automotive import figures of one country as a measure of the exports of the other. However, these statistics cover not only the duty-free trade in motor vehicles and original equipment parts and accessories that comes under the terms of the Auto Pact, but also a large and growing volume of trade in vehicles, parts and accessories that fall outside the Pact - many of which are subject to duty in both countries.

Furthermore, the conventional statistics provide no measure of Canada's trade with third countries which is directly related to the provisions of the Agreement. As a result, the multilateral nature of the Canadian provisions which permit domestic manufacturers to import overseas vehicles and original equipment parts duty-free is not reflected in conventional statistics. While the success or failure of the Automotive Agreement is to a considerable extent judged in both Canada and the United States by the trade balance, no attempt has been made by Canada to present statistics which distinguish between the pattern of trade carried out under the terms of that Agreement and that which falls outside of it. There have been suggestions that such a distinction is irrelevant, but it should be self-evident that a differentiation between automotive trade conducted under the Pact and outside the Pact is essential to an understanding of any underlying problems that may exist, which in turn is a first prerequisite for seeking their solution.

Table 3.1 shows the pattern of total Canada-U.S. automotive merchandise trade for selected years as published by Statistics Canada, which use U.S. import figures as the basis for Canadian exports.

TABLE 3.1

CANADIAN-U.S. AUTOMOTIVE TRADE FOR
SELECTED YEARS AS PUBLISHED BY STATISTICS CANADA

(Cdn. \$ millions)

<u>U.S. Imports from Canada</u>	<u>1966</u>	<u>1968</u>	<u>1971</u>	<u>1974</u>	<u>1977</u>
Motor Vehicles	488	1603	2536	3407	5996
Parts	389	846	1496	1953	3721
Tires and Tubes	9	9	8	64	144
Total	886	2458	4040	5424	9861
<u>Canadian Imports from U.S.</u>					
Motor Vehicles	384	998	1321	2531	3948
Parts	1093	1820	2485	3892	6847
Tires and Tubes	10	29	36	219	153
Total	1487	2847	3842	6642	10948
<u>Balances</u>					
Motor Vehicles	104	605	1215	876	2048
Parts	(704)	(974)	(989)	(1939)	(3126)
Tires and Tubes	(1)	(20)	(28)	(155)	(9)
Total	(601)	(389)	198	(1218)	(1087)

See Appendix A-1 for other years.

For several years, the annual report which the President of the United States is required to submit to Congress on the operation of the Automotive Products Trade Act of 1965 has listed in considerable detail the value of imports from Canada of motor vehicles, original equipment parts and accessories which come under the provisions of the Pact. As previously noted, comparable data on the value of Canadian imports from the United States has never been published in this country.

Because of the importance of obtaining such information, an analysis has been undertaken to compile figures indicating the value of imports from the United States within and outside of the Automotive Products Trade Agreement (APTA). This data, together with the figures on U.S. imports from Canada contained in the President's annual reports to Congress, then made it possible to obtain a reasonably accurate measure of the flow of automotive trade between the two countries and the net balance as it relates to products covered by the Agreement and those that are excluded.

Table 3.2 brings together U.S. figures derived from the President's report and Canadian figures obtained from our analysis to provide for the first time a clear indication of the value of automotive trade between the two countries within and outside of the Agreement.

During the period from 1966 to 1977, total automotive trade between Canada and the United States rose from \$2.42 billion to \$20.17 billion. Trade under APTA increased in value from \$2.1 billion to \$19.5 billion, while that outside APTA rose from \$242.5 million to \$1.12 billion.

TABLE 3.2

CANADIAN-U.S. AUTOMOTIVE TRADE FOR SELECTED YEARS

WITHIN AND OUTSIDE THE AUTOMOTIVE PRODUCTS TRADE AGREEMENT

(Cdn. \$ millions)

	<u>1966</u>	<u>1968</u>	<u>1971</u>	<u>1974</u>	<u>1977</u>
<u>U.S. IMPORTS FROM CANADA</u>					
<u>Imports Under APTA</u>					
Motor Vehicles	481.4	1588.0	2473.6	3391.0	5942.8
Parts	338.8	789.4	1386.2	1816.9	3488.4
Sub-Total	820.2	2377.4	3859.8	5207.9	9431.2
<u>Imports Outside APTA</u>					
Motor Vehicles	4.4	9.9	62.1	14.3	51.4
Parts	49.2	54.3	109.3	136.1	112.7
Tires and Tubes	8.6	8.6	8.1	63.6	143.6
Sub-Total	62.2	72.8	179.5	214.0	307.7
<u>CANADIAN IMPORTS FROM U.S.</u>					
<u>Imports Under APTA</u>					
Motor Vehicles	371.3	1073.4	1283.6	2443.9	3846.1
Parts	989.7	1705.7	2313.5	3546.6	6218.3
Sub-Total	1361.0	2779.1	3597.1	5990.5	10064.4
<u>Imports Outside APTA</u>					
Motor Vehicles	38.5	37.7	75.6	108.1	206.2
Parts	132.1	149.4	213.6	341.4	511.7
Tires and Tubes	9.7	29.1	36.4	218.1	153.1
Sub-Total	180.3	216.2	325.6	667.6	871.0
<u>TRADE BALANCES</u>					
<u>Under APTA</u>					
Motor Vehicles	110.1	514.6	1190.0	947.1	2096.7
Parts	(650.9)	(916.3)	(927.3)	(1729.7)	(2729.9)
Total	(540.8)	(401.7)	262.7	(782.6)	(633.2)
<u>Outside APTA</u>					
Motor Vehicles	(34.1)	(27.8)	(13.5)	(93.8)	(154.8)
Parts	(82.9)	(95.1)	(104.3)	(205.3)	(399.0)
Tires and Tubes	(1.1)	(20.5)	(28.3)	(154.5)	(9.5)
Total	(118.1)	(143.4)	(146.1)	(453.6)	(563.3)

For other years, see Appendix A-2.

SOURCE: See Text.

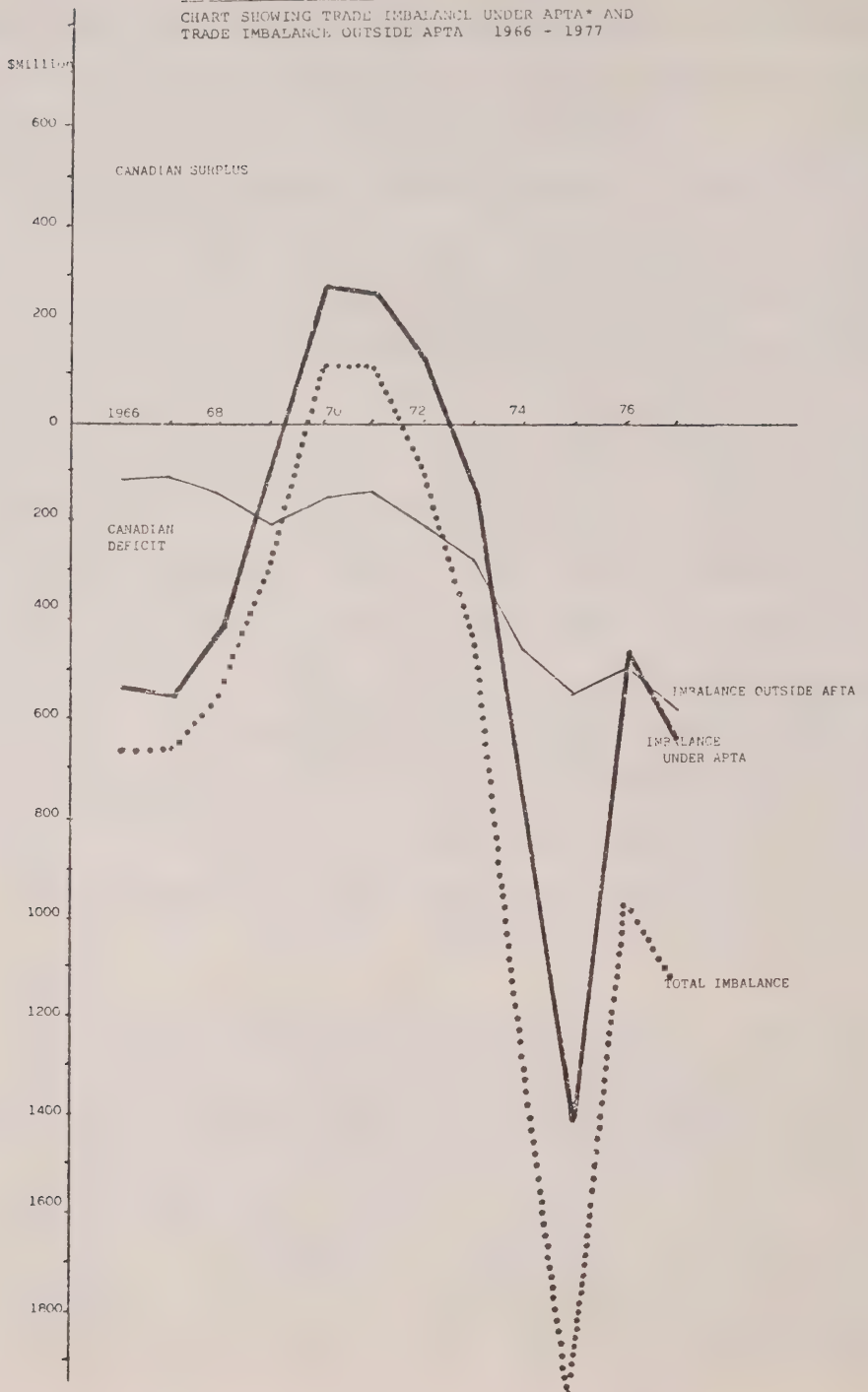
Because of differences in classification,¹ the combined balance of APTA and non-APTA trade does not precisely match the overall trade balance shown by the conventional Statistics Canada figures. The underlying trend, however, is apparent and very revealing. In 1966, 82 per cent of the combined deficit was the result of a shortfall in trade under APTA. In 1971, there was a surplus in APTA trade of \$263 million and a deficit outside of APTA of \$146 million. In 1975, shown in Appendix A-2, the deficit under APTA peaked at \$1.4 billion, while the non-APTA deficit was \$547 million. By 1977, the APTA deficit had fallen to \$633 million, but the non-APTA deficit climbed to \$563 million and accounted for 47 per cent of the total. In 1966, the APTA deficit represented 25 per cent of total Canadian-U.S. trade under this category and the non-APTA deficit was equal to 49 per cent of trade outside the Pact. In 1977, the APTA deficit was equivalent to 3 per cent of total trade under the Agreement, while the deficit balance in trade outside the Pact remained close to 49 per cent of the total trade in this category. Chart 1A shows the trend of the Canada-U.S. trade balance under APTA and outside APTA.

1

The figures on Canadian imports from the United States have been drawn from the series "Commodity Imports by Tariff Items" prepared by the External Trade Division of Statistics Canada, which is not published but is available to the public. The breakdown of "Commodity Imports by Tariff Items" does not correspond exactly to that provided by the External Trade Division of Statistics Canada in the series it publishes on the "Canadian International Trade Classifications" basis. There are some differences between the two sets of numbers (e.g. imports of automotive textile and furniture are included in the former but not in the latter). The compilation of "Commodity Imports by Tariff Items" forms the basis for preparing the Canadian International Trade Classifications' series, however, and discrepancies between the two sets of data are for the most part not significant.

CHART 1A

CANADA/U.S. TRADE BALANCE IN AUTOMOTIVE PRODUCTS
CHART SHOWING TRADE IMBALANCE UNDER APTA* AND
TRADE IMBALANCE OUTSIDE APTA 1966 - 1977



Note: AFTA=Canada-U.S. Automotive Products Trade Agreement

It is important to examine the reasons why there have been such sharp swings in the balance of automotive trade between Canada and the United States that is carried on under the provisions of APTA. In order to explore these factors, it is first necessary to develop an understanding of the market structure of the North American industry, which will be outlined later in this chapter.

Automotive trade between Canada and the United States outside of the Pact consists in the main of replacement parts and accessories, off-highway and other special types of vehicles, original equipment parts for these vehicles, and tires and batteries. In 1977, replacement parts and accessories accounted for around \$399 million out of the total non-APTA trade deficit of \$563 million. Much of the trade outside of the Agreement is subject to duty in both countries. In addition, Canadian production that falls outside the Agreement is not counted in the balance for purposes of the Canadian government's CVA and vehicle assembly requirements. As a result, there has been relatively little opportunity or incentive for Canadian producers to rationalize and specialize in an effort to serve the whole North American market.

The fact that the non-APTA deficit has been progressively widening over the years suggests strongly that, despite significant tariff protection, Canadian producers - particularly of replacement parts - have been becoming increasingly uncompetitive. The dilemma now confronting this sector is similar in many respects to that confronting the whole of the Canadian automotive industry before it was given open access to the entire North American market.

As indicated earlier, trade between Canada and the United States, both inside and outside the Pact, tells only part of the story. Canada also conducts a substantial volume of automotive trade with third countries, some of which is related to the Agreement and some of which is not affected by it.

Table 3.3 shows the overall pattern of Canadian and overseas automotive trade as reported by Statistics Canada.

The data in Table 3.3 indicate that a modest Canadian surplus in trade with third countries in 1966 was converted to a modest deficit by 1968. That deficit grew to a peak of \$483 million in 1972 before beginning to recede again, and by 1977 apparently had been cut back to \$111 million. As will be explained shortly, this is another case in which the underlying reality is masked by the conventional statistical approach.

Before dealing with the latter issue, however, it is necessary to provide a breakdown in automotive trade with third countries between that which is related to APTA and that which is not. Under the provisions applying in Canada, a motor vehicle manufacturer may import vehicles and original equipment parts from affiliated companies overseas free of duty in the same way as he may import them from the United States. A significant volume of automotive products is exported by Canadian producers to affiliated companies in third countries, which is also counted as a contribution to Canadian content and assembly ratios. In this case, however, Canadian exports may be subject to duty in the

TABLE 3.3

CANADIAN-OVERSEAS AUTOMOTIVE TRADE

FOR SELECTED YEARS

(Cdn. \$ millions)

	<u>1966</u>	<u>1968</u>	<u>1971</u>	<u>1974</u>	<u>1977</u>
<u>Canadian Exports</u>					
Motor Vehicles	110	133	114	204	614
Parts	42	68	85	142	195
Tires and Tubes	4	3	4	5	7
Re-Exports	6	11	7	7	10
Total	162	215	210	358	826
<u>Canadian Imports</u>					
Motor Vehicles	111	177	374	450	592
Parts	33	60	133	260	235
Tires and Tubes	5	10	27	70	110
Total	149	247	534	780	937
<u>Trade Balances</u>					
Motor Vehicles	(1)	(44)	(260)	(246)	22
Parts	9	8	(48)	(118)	(40)
Tires and Tubes	(1)	(7)	(23)	(65)	(103)
Re-Exports	6	11	7	7	10
Total	13	(32)	(324)	(422)	(111)

For other years see Appendix A-3

SOURCE: Statistics Canada

importing country. Table 3.4 outlines the pattern of overseas automotive trade that is related and unrelated to the Agreement.

What the figures in Table 3.4 suggest is that in recent years Canada has enjoyed a large and growing surplus of trade with third countries in products related to APTA and, at the same time, has continued to experience a continuing deficit of substantial proportions in trade unrelated to APTA. In 1977, the APTA related surplus came to an estimated \$490 million, while the deficit in trade unrelated to APTA amounted to \$644 million.

If the total flow of trade by Canada with the U.S. and third countries related to APTA is combined, as shown in Table 3.5, a very different picture emerges from that portrayed by conventional data. The figures indicate that a Canadian deficit of around \$250 million in 1968 was transformed into a surplus of \$50 million in 1969 and a surplus of \$422 million and \$360 million in the two succeeding years. The deficit climbed to a peak of \$1.1 billion in 1975 and dropped sharply in the following two years to around \$143 million. At the same time, however, the deficit in global trade outside of APTA has risen from \$329 million in 1968 to \$1.2 billion in 1977. Chart 1B indicates the trend of global trade balances in automotive products under APTA and outside APTA.

Over the whole of the period from 1966 to 1977, the cumulative deficit in Canada's automotive trade under APTA amounted to \$2.1 billion. This was equivalent to only 1.9 per cent of the total trade related to

TABLE 3.4

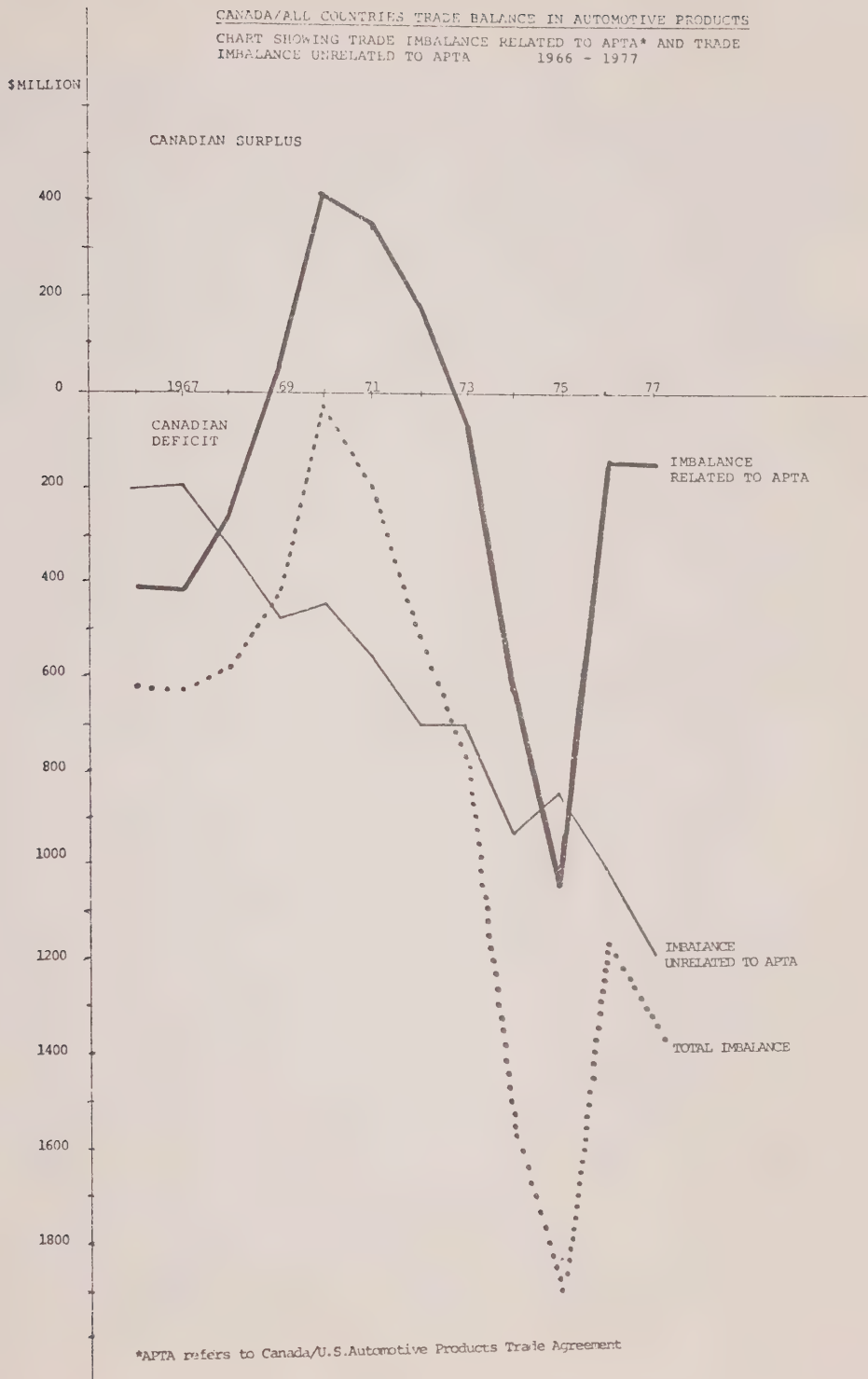
CANADIAN-OVERSEAS AUTOMOTIVE TRADE FOR SELECTED YEARS
 WITHIN AND OUTSIDE THE AUTOMOTIVE PRODUCTS TRADE AGREEMENT
 (Cdn. \$ millions)

	<u>1966</u>	<u>1968</u>	<u>1971</u>	<u>1974</u>	<u>1977</u>
<u>CANADIAN EXPORTS TO OVERSEAS COUNTRIES</u>					
<u>Under APTA</u>					
Motor Vehicles	101.3	120.8	97.8	177.5	546.5
Parts	36.0	49.5	60.8	102.8	146.3
Total	137.3	170.3	158.6	280.3	692.8
<u>Outside APTA</u>					
Motor Vehicles	6.7	11.2	16.2	26.5	67.5
Parts, Tires and Tubes	16.0	19.5	24.2	39.2	55.7
Total	22.7	30.7	40.4	65.7	123.2
<u>CANADIAN IMPORTS FROM OVERSEAS COUNTRIES</u>					
<u>Under APTA</u>					
Motor Vehicles	1.9	8.2	31.8	51.5	73.3
Parts	6.0	11.5	39.1	91.3	128.9
Total	7.9	19.7	60.9	142.8	202.2
<u>Outside APTA</u>					
Motor Vehicles	86.8	180.5	355.3	405.4	563.0
Parts, Tires and Tubes	26.5	36.0	105.2	148.8	203.9
Total	113.3	216.5	460.5	554.2	766.9
<u>BALANCES</u>					
APTA Related	129.4	150.0	97.7	137.5	490.6
Unrelated to APTA	(90.6)	(185.8)	(420.1)	(488.5)	(643.7)

For other years, see Appendix A-4

SOURCE: See text.

CHART 1B



the Agreement. By contrast, the deficit in automotive trade unrelated to APTA during this same period totalled \$7.7 billion, which was equivalent to 57 per cent of total automotive trade outside the Pact.

This breakdown of trade inside and outside of the Pact also does not tell the whole story because of another important factor that has to be taken into account in the equation. A substantial volume of original equipment parts are annually exported to Canada from the United States which are not incorporated in vehicles assembled in this country. They are transferred to Canada to be crated in Canada for export to third countries in what is known as C.K.D. form — that is, "completely knocked down". A certain amount of Canadian value added is contributed in the packaging and handling process and, in some cases, also as a result of the inclusion in the crates of some original equipment parts manufactured in this country.

Canada has been attractive as a source of undertaking C.K.D. operations essentially to serve U.S. companies because of long experience and resulting efficiency. Until August of 1977, a further attraction stemmed from the fact that the Canadian auto producers were permitted to count C.K.D. units as vehicles for purposes of meeting their assembly to sales ratio. Under the current statistical practice, components exported from the United States to Canada for incorporation in C.K.D. shipments are classified as parts imports and admitted duty-free under the provisions of APTA. When they are subsequently exported, sometimes with the addition of Canadian-made components, they are classified in the

statistics as vehicles and the full value credited to Canadian exports of vehicles to third countries. Thus, in this particular operation Canada serves mainly as a conduit for the transshipment of U.S. automotive products to third countries. The credit in Canadian trade statistics as a shipper of motor vehicles to countries abroad arising from the C.K.D. operation is not an accurate reflection of the nature of this trade.

The effect of these transactions in parts for C.K.D. is to increase significantly the apparent deficit in Canada's automotive trade — and in particular original equipment parts trade — with the United States under the Agreement. From the perspective of Canada's overall balance of payments position, no problem arises because the import of parts for C.K.D. from the United States is balanced by their subsequent export to third countries as vehicles. But the way in which the movement of these parts is recorded in the statistics also has an important bearing on public perceptions about the nature of our automotive trade. Canada's deficit balance in automotive trade with the United States under the Pact appears to be significantly larger than it is in reality. Perhaps equally important is the fact that attribution of the full value of C.K.D. shipments overseas serves to conceal the full extent of Canada's real deficit with third countries and, hence, the full magnitude of the problems confronting us in that sector.

Our analysis of the data made available to the Commission by the auto companies indicates that the value of parts imported from the United States for inclusion in C.K.D. shipments is currently running in

the vicinity of \$400 million. The value added in Canada amounted to approximately \$150 million, bringing the total value of C.K.D. exports to third countries to approximately \$550 million. If allowance is made for the value of U.S. made parts that, in effect, only flowed through Canada, it is apparent that Canada's recent deficit with third countries in automotive trade was closer to some \$500 million than the approximate \$110 million indicated by Statistics Canada. By the same token, if the \$400 million or so is taken out of the APTA deficit in trade with the United States, it will be seen that a more valid indication of this deficit currently is more like \$250 million.²

In the second volume of the report published earlier this year on Canada's Trade Relations with the United States, the Senate Committee on Foreign Affairs recalled that during his testimony before it, Roy Bennett, President of the Ford Motor Co. of Canada, had advocated that figures on the gross trade in parts should be broken down to show "those parts exported that stay exported and the parts that are imported that stay imported". The Committee contended, and Mr. Bennett acknowledged, that to provide an accurate portrayal of the trade picture on that basis, it would also be necessary to extend this approach to cover vehicles as well as parts.

"There is no doubt that the gross balances of the present trade figures provide an imperfect picture of which activities are generating

² The Commission has the precise figures for this C.K.D. trade in 1977 and how it affects Canada's trade both with the U.S. and overseas countries. However, we are precluded from using the exact figures because of the Commission's commitment to the two motor vehicle companies concerned.

a surplus or deficit in the balance of payments," the Senate report asserted. "The Committee proposes a better procedure for achieving not only the broad picture, but also a dissected view of the parts and vehicle trade ... Therefore, the Committee recommends that the balance of automotive trade figures be disaggregated to show the net value of original equipment parts balance and the amount of net Canadian value-added in assembly."

While the Commission sees merit in the recommendations of the Senate Committee to disaggregate the trade statistics in the automotive sector, it has not been able because of time constraints to carry this work forward to the point where it can be absolutely certain of producing precise and accurate results. However, an equally meaningful way of gaining an insight into the level of activity in vehicle assembly and parts production is to measure the amount of Canadian value-added in each sector in relation to that in North America. This relationship is examined in the following section.

Up to this point, the analysis has concentrated on merchandise trade in automotive products, which has long been the central focus of public discussion. In addition to figures on merchandise trade, however, Statistics Canada also publishes data on selected items that make up non-merchandise transactions related to the auto industry between Canada and the United States. These selected current account transactions include interest payments, dividends, management fees, charges for services related to tooling, and charges for research and development. A statistical sample of these transactions indicates that the great bulk of these payments related to trade conducted under APTA.

Table 3.6A provides a picture of the invisible transactions with the United States related to the automotive trade in recent years.

Before concluding this discussion, it is useful to examine the global picture of Canada's total automotive trade in goods and services to the extent that is possible. Table 3.6B indicates the balance of Canadian merchandise trade with all countries that is related and unrelated to APTA during the period from 1966 to 1977. On the non-merchandise side, figures are available only in the case of selected items of trade between Canada and the United States, as drawn from Table 3.6A. While no breakdown is available on Canada's non-merchandise balance with the rest of the world, there is every reason to believe that it is negligible. The Table shows that Canada's total current account deficit in automotive trade on this basis rose from \$781 million in 1966 to a peak of \$2.2 billion in 1975, dropping to \$1.8 billion by 1977. By any measure, therefore, the total automotive deficit is clearly an important factor in Canada's overall current account deficit.

TABLE 3.6A

THE CANADIAN-U.S. AUTOMOTIVE BALANCE IN NON-MERCHANDISE TRADE
RELATED TO THE APTA FOR SELECTED YEARS

(Cdn. \$ millions)

	<u>1966</u>	<u>1968</u>	<u>1971</u>	<u>1974</u>	<u>1977 *</u>
Non-Merchandise					
Transactions	(161.0)	(174.0)	(234.0)	(337.0)	(488.0)

For other years see Table 3.6B

* Preliminary

SOURCE: Statistics Canada, Catalogue 67-201 for non-merchandise trade.

TABLE 3.6B
CANADIAN IMBALANCE IN CANADA/ALL COUNTRIES CURRENT ACCOUNT
TRANSACTIONS RELATIVE TO THE AUTOMOTIVE SECTOR

[illegible]

SOURCE: Row (a) and (b) from Table 3.5
Row (c) from Statistics Canada Catalogue 67-201, 1977 figure preliminary

Canadian Automotive Production,
Consumption and North American "Market Shares"

The starting point for any discussion of Canada's position with respect to the North American automotive industry usually has been its share of sales, or consumption, of North American type vehicles in the Canadian domestic market. Traditionally, this "share" has been calculated on the basis of the number of North American type vehicles sold in Canada, rather than their value. An estimate of the share of the domestic market in relation to that of the United States based on the number of vehicles sold, however, can be misleading because of the likelihood of a quite different mix of vehicles sold in the two markets in terms of type and value.

In the "Review of the North American Automotive Industry" published in April, 1977, the Canadian Automotive Task Force — the Arthur Report — noted that Canada's share of North American consumption as measured in terms of the number of vehicles sold fluctuated between 6 and 8 per cent from 1965 to 1973, but then grew to between 10 and 11 per cent in 1974 and 1975. "This growth in Canadian share of North American sales was due to the recession in the United States and the relative buoyancy of the Canadian market," the report pointed out. "As a result of the recovery of sales in the United States in early 1976, Canada's percentage of total North American sales returned to more traditional levels." By 1977, Canadian consumption of North American type vehicles in numerical terms came to 8.4 per cent.

An alternative method that provides a better appreciation of Canada's real share of the North American market is one based on the value rather than the number of vehicles sold. Such a calculation of sales of vehicles in Canada by value provides a basis for comparison with the total value of automotive output produced in Canada and in North America. Prior to the publication of the United States International Trade Commission study of the Automotive Agreement in 1976, no figures had previously been available publicly on the value of vehicles sold in Canada and the United States. Similarly, no figures had ever been published previous to that U.S. report on the amount of Canadian value-added in automotive production. Such figures, which have been brought up to date in this Report on the basis of information submitted by the vehicle manufacturers, provide a more accurate measure of the value of Canadian automotive output and its relationship to the value of Canadian consumption.

While such a common basis of comparison of production was provided for the first time in the United States International Trade Commission report of 1976 as a result of figures provided by the major motor vehicle manufacturers, no similar figures have previously been available in Canada. Figures on the value of production and consumption in Canada and North America have been obtained by this Commission. Some of these figures apply to the industry as a whole. Those that are confined to the major motor vehicle manufacturers nevertheless cover the bulk of automotive production.

As a first step in examining the relationship between Canadian automotive production and consumption, Table 3.7 provides data based on information provided by the "Big Four" manufacturers on their Canadian value-added in the assembly of vehicles and the component parts either incorporated in those vehicles in Canada or exported for incorporation in assembly by affiliated companies in the United States or overseas. Such parts include their own products as well as those made by independent companies.

To provide some measure of comparability between the value of Pact-related automotive output produced in Canada in relation to total North American output and the value of automotive vehicles and original equipment parts consumed in Canada in relation to North American sales, further information was obtained from the Big Four manufacturers on the annual value of their sales in Canada and the United States. The latter is determined on the basis of the cost at which vehicles move from the factory to the first level of distribution.³

Table 3.7 indicates that Canadian value-added in assembly and original equipment parts production in 1977 was more than five times the CVA in 1964, the year prior to the signing of the Agreement. From 1964, when Canadian value-added amounted to 3.7 per cent of the value of total North American auto production associated with the "Big Four", the proportion of CVA rose slowly to a peak of 6.7 per cent in 1970, which was the result of a number of exceptional factors. During the next three

³ See Appendix B for an explanation of how the values for production and consumption were determined.

TABLE 3.7

VALUE OF CANADIAN PRODUCTION COMPARED TO VALUE OF
CANADA/U.S. PRODUCTION RELATED TO
THE CANADA/U.S. AUTOMOTIVE PRODUCTS TRADE AGREEMENT
- THE BIG FOUR -

<u>Year</u>	<u>Canadian Value-Added in Motor Vehicles and Parts including CVA in Exported O.E. Parts</u>	<u>Value of Motor Vehicle Production in Canada and U.S.A.</u>	<u>Canadian Value-Added as a Percentage of Canada/U.S. Motor Vehicle Production</u>
(In Million \$ Canadian)			
1964	785	21,449	3.7%
1965	956	28,390	3.4%
1966	1,135	27,276	4.2%
1967	1,145	24,660	4.6%
1968	1,357	31,006	4.4%
1969	1,621	31,632	5.1%
1970	1,643	24,572	6.7%
1971	1,710	33,177	5.2%
1972	2,006	36,238	5.5%
1973	2,340	42,781	5.5%
1974	2,449	37,170	6.6%
1975	2,716	42,494	6.4%
1976	3,346	55,534	6.0%
1977	4,006	72,229	5.5%

NOTE: Canadian value added data are model year data for the 12 months beginning on August 1st of the years noted, while the transfer value data for motor vehicles are calendar year data for the 12 months beginning on January 1 of the years noted.

SOURCE: Compiled from company responses to the Inquiry and the Canadian Government

years, it varied between 5.2 and 5.5 per cent. It climbed again to more than 6 per cent during the period of 1974 to 1976 — when other special factors were in play — and then declined again in 1977 to the 5.5 per cent level.

Table 3.8 shows the cost of sales in Canada as a percent of total North American consumption from 1964 to 1977 for the Big Four and the Canadian value-added as a percentage of North American production, derived from Table 3.7. Over the period, there have been significant shifts in Canada's share of North American production and consumption, which in turn reflect differences in market conditions, production capacity and the model mix in any given year.

In the year prior to the Agreement, Canada's share of North American production amounted to 3.7 per cent and its share of consumption amounted to 6.3 per cent. The proportion of Canadian production in relation to North American consumption began to climb gradually through to 1970. During the years 1970 to 1973, the share of production and consumption was almost identical, but during the years 1974 to 1976 the difference between the two ratios widened significantly. This was primarily due to the fact that motor vehicle sales in the United States during the recession period declined sharply, while Canadian sales were well sustained.

A somewhat different perspective on automotive activity in Canada can be gained by comparing the total Canadian value-added to the cost of sales of vehicles in Canada. Figures obtained from the major motor vehicle manufacturers in Canada by this Commission and data for the industry as a whole that have been drawn from other sources are provided in Table 3.9.

TABLE 3.8

VALUE OF CANADIAN PRODUCTION AND CONSUMPTION
 COMPARED TO VALUE OF CANADIAN & U.S.A. PRODUCTION AND CONSUMPTION
 RELATED TO THE AUTOMOTIVE PRODUCTS TRADE AGREEMENT

- THE BIG FOUR -

	<u>PRODUCTION</u>	<u>CONSUMPTION</u>
	Canadian Value Added as a Percentage of Canada & U.S.A. Motor Vehicle Production	Cost of Sales in Canada as a Percentage of Canada & U.S.A. Motor Vehicle Consumption
1964	3.7%	6.3%
1965	3.4	5.3
1966	4.2	5.9
1967	4.6	6.6
1968	4.4	6.0
1969	5.1	6.3
1970	6.7	7.1
1971	5.2	5.2
1972	5.5	5.9
1973	5.5	6.8
1974	6.6	9.1
1975	6.4	9.7
1976	6.0	8.9
1977	5.5	7.7

NOTE: Canadian value added and cost of sales data are model year data for the 12 months beginning on August 1st of the years noted, while values for motor vehicles are calendar year data for the 12 months beginning on January 1 of the years noted.

SOURCE: Compiled from company responses to the Inquiry and the Canadian Government.

TABLE 3.9

TOTAL CANADIAN VALUE ADDED PRODUCED
AS A PERCENT OF COST OF SALES IN CANADA

<u>Years</u>	<u>Total All Companies</u>
1964	58%
1965	63%
1966	69%
1967	68%
1968	71%
1969	80%
1970	91%
1971	96%
1972	90%
1973	79%
1974	71%
1975	66%
1976 ^P	67%
1977 ^P	72%

P = Preliminary

SOURCE: Department of Industry, Trade and Commerce

The data show that in 1964, the year prior to the Agreement, Canadian value-added as a per cent of the cost of sales in Canada amounted to only 58 per cent. This ratio climbed quickly in the years that followed the signing of the Pact, reaching a peak in 1971 of 96 per cent, which coincided with the period when Canada had significant surpluses in its APTA related trade with the United States and third countries as shown in Table 3.5. The CVA in relation to sales in Canada declined to 79 per cent in 1973 and dropped off to around 66 per cent in 1975 and 1976 before climbing again in 1977 to 72 per cent.

That there is a very close causal relationship between Canadian value-added as a percentage of sales in Canada and Canada's balance of trade with the United States in automotive products which fall under the Agreement is indicated by Table 3.10. When CVA in relation to sales is low, the Canadian deficit on APTA trade with the United States is high. Similarly, when the CVA, as a percentage of cost of sales, moves closer to balance, Canada's trade balance becomes more favourable. In 1971, for example, when the CVA was equivalent to 96 per cent of sales, Canada had a surplus equal to 3.5 per cent of the total volume of trade under the Agreement between the two countries. The historical relationship indicates that Canada - U.S. trade under APTA will normally be in balance when the CVA-to-sales ratio is around 87 per cent. By the same token, it is estimated that Canada's total trade with the United States and third countries related to APTA will be approximately in balance when the ratio of Canadian value-added

TABLE 3.10

CAUSAL RELATIONSHIP BETWEEN
CANADA/U.S. APTA TRADE IMBALANCE AND
CANADIAN VALUE ADDED IN AUTOMOTIVE PRODUCTION

	<u>Canadian Value Added as Percent of Cost of Sales in Canada</u>	<u>Canada Trade Imbalance as Percent of Total Canada/U.S. APTA Trade</u>
	(X)	(Y)
1966	69	- 24.7
1967	68	- 15.8
1968	71	- 7.8
1969	80	- 1.4
1970	91	4.4
1971	96	3.5
1972	90	1.5
1973	79	- 1.5
1974	71	- 7.0
1975	66	- 11.1
1976	67	- 3.0
1977	72	- 3.2

REGRESSION EQUATION:

$$Y = - 51.22 + 0.59 X$$

SOURCE: Data from Table 3.9 and Appendix A-2.

to the cost of sales is around 82 per cent.⁴

To obtain a better understanding of the close interrelationship between the value of automotive production in Canada, the sales of vehicles in Canada, and the balance of Canadian-U.S. automotive trade under APTA, it is necessary to examine some of the special factors that have influenced the development of the industry.

An inevitable result of the process of rationalization and specialization of North American automotive production that began with the signing of the Agreement in 1965 was a substantial increase in the volume and proportion of exports flowing in both directions. In order to achieve the levels of efficiency of their U.S. counterparts, both Canadian assembly and parts manufacturers were compelled to develop large-scale production of a limited number of models or components. Because of the limited size of the Canadian market for most such products, it was essential to turn to the U.S. market to provide an outlet for a substantial proportion of the greatly increased output necessary to achieve the economies of scale. Similarly, it was also essential to turn to the United States for the importation of a large volume of vehicles and parts that were most economically available from that source.

⁴ This balance of trade occurs despite the fact that CVA is less than the cost of sales because the latter two figures are calculated on a somewhat different basis. Unlike CVA, the cost of sales includes additional costs such as management fees, tooling, engineering and interest charges, and dividends payable to the parent companies.

In 1964, only 13 per cent of the total value of original equipment parts produced in Canada of \$690 million were exported. In 1977, 69 per cent - \$3.0 billion - of original equipment parts were exported out of total production of \$4.4 billion. In 1965, imports of original equipment parts from the United States for incorporation into vehicles assembled in Canada amounted to only 6.3 per cent of total North American parts purchases. In 1977, the proportion was 11 per cent.

Whereas there were practically no exports of motor vehicles from Canada to the United States in 1965, by 1977, 67 per cent of all motor vehicles assembled in Canada were exported to the United States. Conversely, 6.5 per cent of the vehicles sold in Canada in 1964 were imported from the United States and by 1977, the proportion had risen to 64 per cent.

During the period between 1971 and 1973, when Canadian value-added from production came close to matching the value of vehicle sales in Canada, there were a number of factors working in favour of this country. A substantial volume of new automotive output was beginning to come on stream as a result of heavy investment in new plants and equipment during the latter part of the 1960s. U.S. sales, on which the level of Canadian output depends so heavily, were increasing sharply. In addition, Canada was then producing a mix of cars that was heavily weighted toward the smaller sized vehicles that were becoming increasingly popular in those years.

By 1974, however, the pendulum began to swing the other way. The major factor was the sharp downturn in automotive sales in the United States as the result of the impact of the energy crisis and a severe economic recession, and the relative buoyancy of sales in Canada. Sales of North American type motor vehicles in the United States during 1974 dropped by 21 per cent from the record of the year before and in 1975 were 26 per cent below the level in 1973. By contrast, Canadian vehicle sales increased by 6.6 per cent in 1974 over 1973 and by a further 5.6 per cent in 1975. Because of the pattern of procurement previously described, the drop in sales south of the border led to a corresponding decline in demand for both Canadian-made vehicles and parts. Canadian demand for U.S. produced vehicles and parts, on the other hand, was well sustained. Because of the impact of market forces in the United States, which accrued quite independantly of any conceivable influence of the Auto Agreement or of the trade or economic policies of the Canadian government, our automotive trade deficit with the United States increased sharply and CVA in relation to sales dropped substantially.

There were, in addition, other forces that tended to reinforce these results, although their impact cannot be measured with any precision. These included the appreciation of the Canadian dollar to a significant premium in terms of U.S. currency and the faster pace of Canadian inflation, on both the price and cost side. Both tended to undermine Canada's competitive position - particularly for parts produced by independant manufacturers. A shift in the mix

of production to a greater proportion of larger sized cars at a time when consumers were becoming increasingly conscious about fuel economy tended to further diminish the U.S. market for vehicles assembled in Canada.

In more recent years, the merchandise balance has again been swinging in Canada's favour. By 1977, U.S. motor vehicle sales were only marginally below the peak in 1973. In Canada, sales of North American type vehicles in 1977 of 1,136,000 vehicles were moderately below the record of 1,146,000 vehicles set in 1975. The moderation in the increase of Canadian wages and salaries, and the substantial depreciation of the Canadian dollar in relation to U.S. and a number of other currencies that began in late 1976 also worked to bolster the competitive position of the Canadian automotive industry. As a result of the continued strong growth of U.S. vehicle sales in 1978, preliminary data suggest that Canada's trade with the United States under the Agreement will move close to a balance.⁵

5

For the first seven months of 1978, preliminary data show Canada experienced \$211 million deficit in trade with the U.S. under APTA. After adjustment for "flow through" of U.S. parts for C.K.D. purposes, Canada experienced a surplus of about \$60 million.

The Position and Structure of the Canadian Automotive Parts Industry

Over the past three or four years, public attention has increasingly been focussed on the Canadian automotive parts industry. It has been represented, particularly by the Automotive Parts Manufacturers' Association of Canada (APMA) as the organization representing independent Canadian and U.S. controlled companies operating in this country, that the parts sector has not fared well under the Auto Pact. It has been argued that the assembly-to-vehicle sales ratio established as one of the safeguards has worked against the growth of parts manufacturing in Canada — despite the fact it was in part introduced to meet the concern of parts producers. In its brief to this Commission, the APMA complained that "'fair share' commitments" made under the Agreement "to ensure that all segments of the Canadian automotive industry receive equal benefit, have been largely ignored." As evidence of deeply-rooted problems in this sector of the industry, it was pointed out that Canada's deficit balance of trade with the United States in original equipment parts had risen to more than \$3 billion according to figures published by Statistics Canada, while the surplus on vehicles amounted to more than \$2 billion. As a result of this apparent imbalance of trade in original equipment parts, it was suggested Canadian "consumption" of parts was more than double its production of parts.

Table 3.11 and Chart 2 show the total Canadian value-added by original equipment parts, whether produced by independent parts makers or by the motor vehicle manufacturers, and by motor vehicle assembly. The figures indicate clearly that the growth in Canadian value-added from the production of parts for incorporation in Canadian-made vehicles and for export has far exceeded the increase in CVA contributed by vehicle assembly. Over the period from 1964 to 1977, the amount of CVA produced through assembly has increased 4.3 times, while that produced in the form of original equipment parts has increased 5.9 times. The proportion of CVA contributed by parts production rose from 59 per cent of the total in 1964 to a peak of nearly 72 per cent in 1972 and 1973 before dropping back to 68 per cent in 1977.

Canada's production of original equipment parts as a proportion of total North American production has increased almost without interruption from 1964 to 1977. It is evident from Table 3.12, that the Canadian share of North American original equipment parts production in the year prior to the Auto Pact was only 3 per cent. In 1977, the proportion amounted to almost 8 per cent. It is worth recalling that in that same year the total Canadian value-added through all automotive activities amounted to 5.5 per cent of the value of North American production of vehicles.

One measure that is sometimes employed to indicate the relative position of the parts sector in Canada is a comparison of parts produced and "consumed" in Canada as a percentage of the

TABLE 3.11

TOTAL CANADIAN VALUE ADDED PRODUCED

- THE BIG FOUR -

(in thousand dollars)

Model Year	Non-Parts C.V.A. in Vehicle Production	Parts C.V.A. in Vehicle Production	Original Equipment Parts Exported	Total Canadian Value-Added Produced	Parts C.V.A. as Percent of Total C.V.A.
	a	b	c	d = a + b + c	(b + c) / d
1964	319,294	429,687	36,496	785,477	59.4
1965	379,532	475,750	100,947	956,229	60.3
1966	398,154	537,554	198,943	1,134,651	64.9
1967	360,716	481,780	302,669	1,145,165	68.5
1968	418,490	493,666	444,895	1,357,051	69.2
1969	473,920	559,537	587,509	1,620,966	70.8
1970	482,821	509,910	650,575	1,643,306	70.6
1971	524,922	457,094	728,149	1,710,165	69.3
1972	564,178	562,676	879,228	2,006,082	71.9
1973	657,787	603,624	1,078,736	2,340,147	71.9
1974	739,987	640,285	1,069,117	2,449,389	69.8
1975	876,298	733,442	1,105,988	2,715,728	67.7
1976	1,053,265	724,808	1,568,273	3,346,346	68.5
1977	1,289,796	833,948	1,882,556	4,006,300	67.8

SOURCE: Department of Industry, Trade and Commerce

CHART 2

TOTAL C.V.A. PRODUCED:
 NON PARTS C.V.A. IN VEHICLES, PARTS C.V.A. IN VEHICLES, O.E. PARTS EXPORTED
 BIG FOUR 1964 TO 1977

Millions of
 Dollars

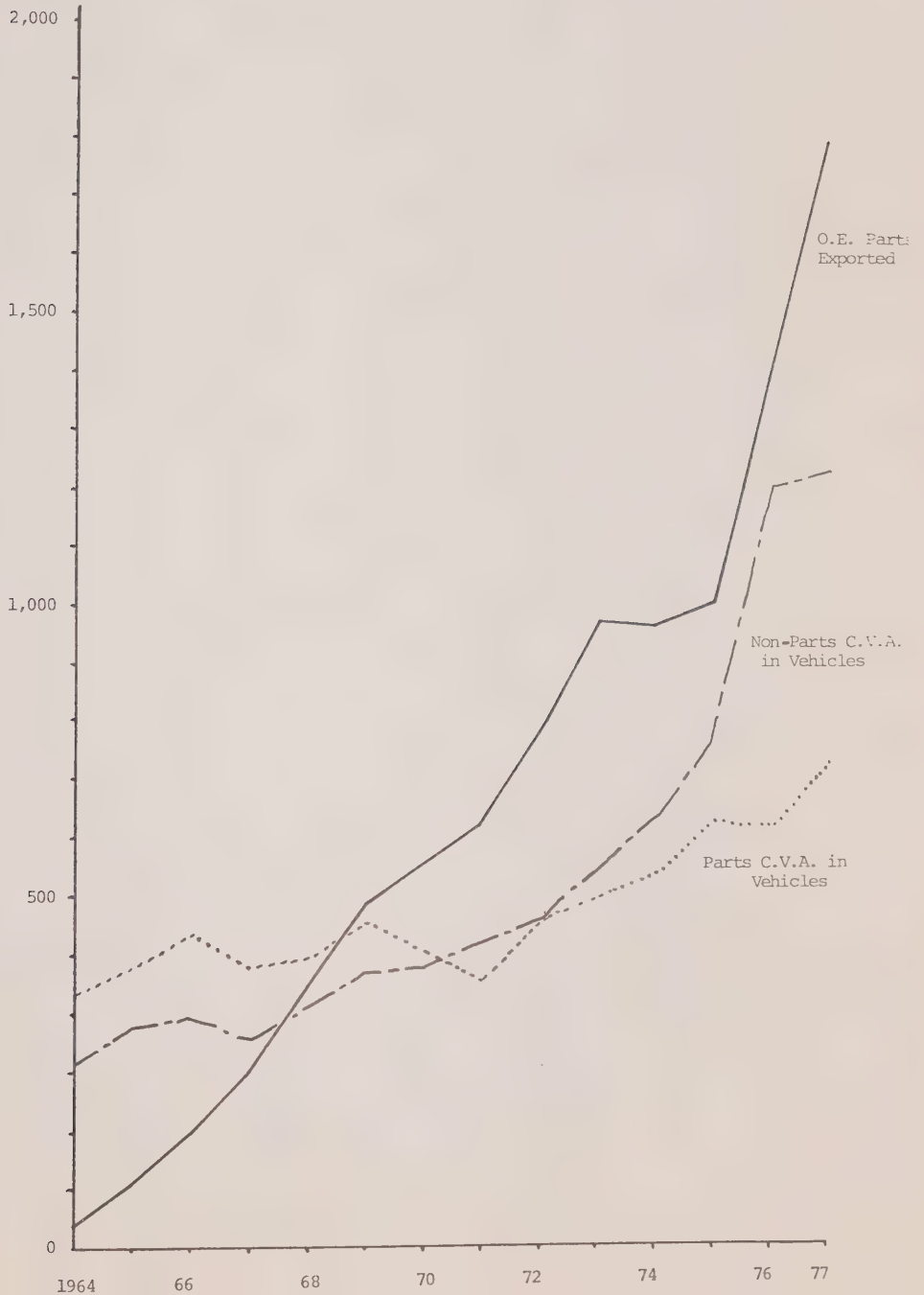


TABLE 3.12

PRODUCTION OF ORIGINAL EQUIPMENT MOTOR VEHICLE PARTS FOR INCORPORATION INTO MOTOR VEHICLES ASSEMBLED
IN CANADA AND U.S.A. 1964 - 1977 (IN CANADIAN \$ MILLIONS) ON THE BASIS OF TRANSFER VALUE

	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977
O.E.M. Production in U.S.														
Motor Vehicle Manufacturers	9,130	11,685	11,468	10,206	12,092	12,893	9,889	13,165	13,668	16,002	15,819	16,080	21,696	27,911
Independent Parts Producers	7,150	9,301	8,885	7,925	8,881	9,466	7,920	9,514	10,355	13,233	12,676	14,795	17,491	22,972
Total U.S.	16,280	20,986	20,353	18,131	20,973	22,359	17,809	22,679	24,023	29,235	28,495	30,875	39,187	50,883
O.E.M. Production in Canada														
Motor Vehicle Manufacturers	92	147	278	307	433	496	509	705	851	928	876	946	1,352	2,011
Independent Parts Producers	407	543	644	740	1,012	1,068	887	1,028	1,196	1,348	1,278	1,443	1,970	2,382
Total Canada	499	690	952	1,047	1,445	1,564	1,396	1,733	2,047	2,276	2,154	2,389	3,322	4,393
Canada's Production as Percent of Total U.S. and Canada Production of O.E.M.														
Parts	3.0%	3.2%	4.5%	5.5%	6.4%	6.5%	7.3%	7.1%	7.9%	7.2%	7.0%	7.2%	7.8%	7.9%
Independent as a Percent of Total Production														
In U.S.A.	43.9%	44.3%	43.7%	43.7%	42.3%	42.3%	44.5%	41.9%	43.1%	45.3%	44.5%	47.9%	44.6%	45.1%
In Canada	81.6%	78.6%	69.9%	70.6%	70.0%	68.3%	63.5%	59.3%	58.4%	59.2%	59.3%	60.4%	59.3%	54.2%

SOURCE: U.S. International Trade Commission for 1964-1974 AND Company Responses to Inquiry, 1975-1977

North American total. In the sense in which the term is generally understood, there is no such thing as original equipment consumption of parts in Canada or the United States. Such parts are only acquired by the manufacturers, either from their own in-house production or from independent companies, for assembly into vehicles.

Quite obviously, a very substantial proportion of original equipment components imported into Canada are incorporated in vehicles which are shipped to the United States. In no sense can these components be said to have been consumed in Canada. Moreover, a very substantial proportion of components imported into Canada are re-exported. It is surely misleading to use the value of components imported for this purpose as an indication that Canadian parts production is falling short of the value of components required for incorporation in vehicles that are consumed in Canada.

The argument of the parts makers with respect to the imbalance in original equipment parts trade is further weakened when account is taken of the very substantial original equipment parts imports that enter into the C.K.D. trade. This, as was noted earlier, is a very special kind of trade that bears virtually no relationship to production and consumption in Canada. It should be acknowledged that the Automotive Parts Manufacturers' Association have noted this anomaly, but they have not been able to adjust their figures because the statistics for C.K.D. trade is not publicly available. From the data supplied earlier, it is quite evident that an adjustment of the order of some \$400 million in 1977... is required to adjust for the C.K.D. trade.

In examining the parts sector of the automotive industry, it is necessary to take account of its particular form and structure. All of the major motor vehicle manufacturers produce a certain proportion of their own parts — some a substantial proportion. The 1977 Review by the Canadian Automotive Task Force estimated that in 1974 there were also some 458 independent companies engaged primarily in the manufacture of parts and accessories. Together with the Big Four, the total came to 462, of which 94 companies exclusively produced original equipment parts, 52 exclusively produced aftermarket parts, and 316 produced for both markets. More than 60 per cent of all original equipment parts output in Canada at that time was produced by the four motor vehicle manufacturers and eight independent multinational firms operating both in Canada and the United States.

There is, however, a significant difference between the structure of the automotive industry in the two countries. Of the total value of automotive production, excluding aftermarket parts, in the United States, 26 per cent is contributed through vehicle assembly operations, as compared to only 20 per cent in Canada, whereas independent parts producers contribute 33 per cent in the United States as compared to 43 per cent in this country.

In terms of parts production only, independent producers account for 45 per cent of the total value of output in the United States, about the same proportion that prevailed in 1964. In Canada, the proportion of total production from independents has declined from 81.6 per cent in 1964 to 54.2 per cent in 1977, but it is still

significantly higher than the ratio in the United States. During this period, the value of original equipment parts produced by independents in Canada increased from \$407 million to \$2,382 million.

In its submission to the Commission, the United Auto Workers maintained: "The media has often presented the problem (of the auto industry) as that of a small, weak independent parts sector. The facts are, however, that some of the independent parts companies are major multinational corporations (Budd, Dana, Kelsey, Rockwell, Eaton-Yale, etc.) and others may be small but are doing very well competing with U.S. producers. The real problem of the parts deficit is the in-house parts produced by the Big Three."

While it is open to debate as to whether on balance there is any particular problem existing with respect to trade in original equipment parts, it is apparent that if there is an imbalance in the structure of the industry, it is not with respect to the position of the Canadian independent parts producers — who enjoy a far larger proportion of the market than their U.S. counterparts — but with respect to the in-house production of parts by the vehicle manufacturers as is evident from Table 3.13.

In the United States, the vehicle manufacturers operate highly capital-intensive plants to produce a substantial number of technologically-advanced components in great volume. While the amount of employment in such plants is relatively low in relation to the amount of capital employed, the proportion of skilled and semi-skilled

TABLE 3.13

INTERNATIONAL SOURCING PATTERN OF ORIGINAL EQUIPMENT PARTS
OF THE BIG FIVE MOTOR VEHICLE MANUFACTURERS

(In Canadian \$ Millions)

	U.S. Purchases from In-House Suppliers in Canada	Canadian Purchases From In-House Suppliers in U.S.A.	Column (a) - Column (b)
	(a)	(b)	(c)
1965	17.4	522.2	- 504.8
1966	163.7	599.5	- 435.8
1967	209.0	716.1	- 507.1
1968	356.3	1,008.5	- 652.2
1969	406.8	1,298.7	- 891.9
1970	453.6	1,153.3	- 699.7
1971	639.0	1,428.1	- 789.1
1972	763.2	1,556.4	- 793.2
1973	801.7	1,804.0	-1,002.3
1974	713.0	2,083.2	-1,370.2
1975	796.7	2,209.1	-1,412.4
1976	1,165.6	2,772.2	-1,606.6
1977	1,520.6	3,365.8	-1,845.2

	U.S. Purchases from Independent Suppliers in Canada	Canadian Purchases from Independent Suppliers in U.S.A.	
1965	74.3	236.4	- 162.1
1966	112.3	279.8	- 167.5
1967	172.1	304.6	- 132.5
1968	327.4	405.2	- 77.8
1969	430.9	485.5	- 54.6
1970	487.3	505.4	- 18.1
1971	574.5	484.4	90.1
1972	699.3	558.9	140.4
1973	888.4	748.8	139.6
1974	771.4	846.9	- 75.5
1975	875.8	1,051.1	- 175.3
1976	1,221.6	1,283.5	- 61.9
1977	1,530.0	1,519.9	10.1

SOURCE: Compiled from company responses to the Inquiry

jobs is generally significantly higher than that available in assembly operations or other less technically complex parts manufacturing operations. To a considerable extent, in-house parts production by the vehicle manufacturers is concentrated in such major components as engines, automatic transmissions, large stampings and front-end assemblies. At present, the volume of such in-house production by Canadian manufacturing companies is comparatively low.

It may well be that the motor vehicle manufacturers have been reluctant to commit the very heavy capital investment required to establish the production of major component parts in Canada for distribution throughout the North American market because of an underlying concern that changes in the commercial or other economic policies of either Canada or the United States could put the return on such investment at serious risk. By contrast, assembly plants — on which the manufacturers have concentrated their efforts — are less capital-intensive and can more readily be adapted to changing circumstances.

A significant change in the structural balance between assembly and in-house parts production could result from current plans for major additions to the parts production capacity of two of the major vehicle manufacturers. General Motors of Canada is in the process of investing more than \$200 million to double the capacity

of its Walkerville plant for the production of automatic transmissions from 2,000 to 4,000 units per day. Such an increase in output could potentially increase Canadian value-added by at least \$130 million annually to Canadian output and make a substantial improvement to Canada's automotive trade balance. The Ford Motor Co. of Canada is also undertaking an investment of some \$533 million to establish a new plant at Windsor with a capacity to produce 638,000 engines a year. Such output potentially would generate an additional \$110 million annually in CVA and add \$145 million a year to Canada's trade balance.

There remain two other questions that need to be explored with respect to the parts industry — its competitive position and productivity, and its record of profitability, financial capacity and investment.

There have been suggestions in recent months that the productivity of Canadian parts producers is significantly below that in the United States. Although there are many different yardsticks for measuring productivity, all of them have some shortcomings. In 1977, P.S. Ross and Partners was commissioned by the Department of Industry, Trade and Commerce to gather information on the relative productivity of Canadian and U.S. parts makers and to assess the effect of perceived differences in productivity between the two countries. In June, 1978, the management consulting firm reported

that there is "limited comparable productivity data in the Canada/U.S. auto parts industry to either support or refute (the) contention" that a trade deficit in parts was the result of lower Canadian productivity. At the same time, the study reported that most executives of Canadian parts manufacturing companies considered that their firms were at present competitive in the North American market. They were concerned, however, about the danger that their competitiveness could be undermined in the future as a result of the rapid technological change underway in the automotive industry.

The review of the industry by the Canadian Automotive Task Force in 1977 also indicated that the productivity of Canadian parts producers generally matched that of U.S. manufacturers with whom they compete directly. The report noted, however, that their competitive position was less favourable than that of parts plants located in the southern United States, where wages and land costs are generally lower than in the northern U.S. states and Central Canada and substantial inducements of various kinds were frequently offered by state or local governments to encourage their location there.

A rough comparison of productivity (value-added generated per employee) reveals that Canadian producers of automotive parts have improved their position relative to the U.S. since 1967, and have come to within 10 per cent of the U.S. level. The comparison in Table 3.14 does not allow for the difference in types of products manufactured or used as intermediate products, nor for

TABLE 3.14

PRODUCTIVITY IN AUTOMOTIVE PARTS MANUFACTURING

CANADA AND U.S.A. (SIC 325 AND SIC 3714)

VALUE ADDED PER EMPLOYEE

CANADA AS % OF U.S.A.

1967	77.3
1968	75.4
1969	70.8
1970	89.6
1971	87.1
1972	87.8
1973	88.9
1974	87.0
1975	83.6
1976	93.5

SOURCE: Calculations based on Census of Manufacturers, Statistics
Canada and U.S. Department of Commerce

the price structures determined by market factors in both countries. Moreover, the aftermarket producers, which are believed to be less productive than original equipment producers, are included in this comparison and cannot be separated because of the large number of firms which produce aftermarket and original equipment parts. In the absence of disaggregated data, financial comparisons for the major independent parts producers, which concentrate on original equipment, yield the best picture of their relative performance.

The question of the profitability, financial capacity and investment of Canadian parts manufacturers assumes significance in the light of proposals for federal assistance advanced by the Association representing independent parts producers. In a submission last year, the APMA urged the government to establish a \$250 million fund under which loans would be made to independent manufacturers at or below the Canadian prime rate, with the government absorbing any losses resulting from loss of markets for the goods produced through new investments in plant or equipment. In its submission to this Inquiry, the Association further amplified its proposals. It contended that the rate of interest on government loans should be at or below the U.S. prime rate, and it further proposed that increased profits derived from exports be made tax deductible provided such earnings were re-invested in machinery and equipment.

Within the limited time available to the Commission, it was not possible to obtain comprehensive data with respect to the profitability, financial capacity and record of investment of various

classes of parts producers in Canada. We have, however, gathered some information that sheds light on these issues.

Table 3.15 provides a comparison of the before-tax profitability in relation to sales, net asset and net worth of a large sample of automotive parts manufacturers in Canada and the United States, including both in-house operations and that by independent producers. It indicates that average Canadian industry profits in relation to sales have in every year since 1967 to 1975 inclusive been above the mean in the United States — in most cases significantly.

Except in 1967, average Canadian industry profits before taxes in relation to net assets were also generally well above the mean in the United States. A very similar picture is evident with regard to profitability before taxes in relation to net worth of Canadian and U.S. parts producers.

Earlier it was noted that Canadian subsidiaries of the major independent multinational companies play an important role in the production of parts in this country, together with the vehicle manufacturers themselves. Table 3.16 indicates that on both a before-tax and after-tax basis the Canadian subsidiaries of a sample of these multinationals have been significantly more profitable in relation to equity invested over the five-year period from 1973 to 1977 than their U.S. parents.

CANADA/U.S. COMPARISON OF PROFITABILITY
OF AUTOMOTIVE PARTS AND ACCESSORIES MANUFACTURERS

<u>Year</u>	<u>Pretax Profit as Percent of Sales</u>		<u>Pretax Profit as Percent of Net Assets</u>		<u>Pretax Profit as Percent of Net Worth</u>	
	Canada	U.S.A.	Canada	U.S.A.	Canada	U.S.A.
1965	7.1	N/A	11.6	N/A	26.6	N/A
1966	4.6	N/A	6.0	N/A	16.7	N/A
1967	6.0	5.6	8.4	10.8	22.2	20.2
1968	8.7	5.5	13.9	11.1	32.5	21.4
1969	9.5	5.7	14.9	9.8	30.2	22.6
1970	7.8	4.7	11.9	7.9	23.2	17.3
1971	7.4	5.7	12.4	10.0	24.7	22.2
1972	9.4	5.7	16.1	11.6	30.6	22.3
1973	10.1	5.4	18.7	11.1	34.7	22.0
1974	7.5	4.6	11.8	7.5	22.1	20.1
1975	7.9	2.0	11.4	4.8	19.8	12.9

NOTE: Around 145 firms in the U.S. sample, and 200 firms in the Canadian sample.

SOURCE: Robert Morris Associates of U.S.A.,
Statistics Canada special tabulation

TABLE 3.16

CANADA/U.S. COMPARISON OF MAJOR INDEPENDENT
ORIGINAL EQUIPMENT MOTOR VEHICLE PARTS MANUFACTURERS

PROFITABILITY COMPARISON

	(a)		(b)	
	Before Tax Profit as Percent of Net Worth		After Tax Profit as Percent of Net Worth	
	Canadian Operation	U.S. Corporation	Canadian Operation	U.S. Corporation
1976	37.9	21.8	23.1	12.2
1974	24.2	18.4	15.7	10.6
1975	20.6	17.0	12.2	10.3
1976	30.0	25.5	16.5	14.4
1977	35.4	28.2	21.0	15.5
1973-1977	29.9	22.2	17.8	12.6

SOURCE: Computed from Financial Statements, S.E.C. 10K reports.

The high level of profitability of Canadian parts producers evident from the large sample of companies in both countries may be matched against industry-wide figures on capital investment shown in Table 3.17. The data suggest that new capital expenditures by Canadian parts manufacturers as a proportion of the North American total have been sustained at an exceptionally high level. Over the period 1967 to 1977, Canadian capital investment has been equivalent to 14.5 per cent of total North American parts investment.

A rather different investment picture appears to emerge in the case of the major independent parts producers in Canada and the United States. Table 3.16 indicated that the Canadian subsidiaries were relatively more profitable than their U.S. parents. Table 3.18 suggests that they have also consistently had a stronger cash flow over the period 1973 to 1977 when considering after-tax profits, depreciation and deferred taxes as a percentage of net worth alone and as a percentage of both net worth and long-term debt.

As indicated in Table 3.19, however, new capital investment in plant and equipment by the major independents in Canada has been significantly lower in relation to sales than their U.S. counterparts. The five-year total from 1973 to 1977 was significantly less in this country than south of the border. This evidence is reinforced by Table 3.20 which shows that capital expenditures by Canadian companies on new plant and equipment have been substantially below that of their parents in relation to combined after-tax profit, depreciation and deferred taxes.

TABLE 3.17

NEW CAPITAL EXPENDITURES FOR AUTOMOTIVE PARTS AND
ACCESSORIES MANUFACTURERS IN CANADA AND U.S.A.

1964 - 1977

(In Cdn. \$ Millions)			
<u>Year</u>	<u>Canada</u>	<u>U.S.A.</u>	<u>Canada as % of North America</u>
1964	81.4	*	
1965	129.3	*	
1966	174.3	*	
1967	98.5	617.0	13.8
1968	75.7	517.2	12.8
1969	130.2	660.4	16.5
1970	214.7	575.9	27.2
1971	121.6	429.7	22.1
1972	116.4	1102.6	9.5
1973	153.9	1033.7	13.0
1974	197.7	1261.6	13.5
1975	151.7	1133.6	11.8
1976	164.3	948.6	14.8
1977	229.1	1460.0 Est.	13.6

NOTE: * U.S. data before 1967 not compatible
with later statistics

SOURCE: Statistics Canada (data relate to SIC 325).
U.S. Bureau of Census, Annual Survey of
Manufacture (data relate to SIC 3714).

TABLE 3.18

CANADA/U.S. COMPARISON OF MAJOR INDEPENDENT
ORIGINAL EQUIPMENT MOTOR VEHICLE PARTS MANUFACTURERS

CASH FLOW COMPARISON

After Tax Profit, Depreciation and Deferred
Taxes (P, D, and DT) as percent of Net Worth
and Long Term Debt

	<u>P, D and DT as Percent of Net Worth</u>		<u>P, D and DT as Percent of Net Worth and Long Term Debt</u>	
	Canadian Operation	U.S. Corporation	Canadian Operation	U.S. Corporation
1973	39.6	21.5	26.3	14.8
1974	30.4	22.2	21.7	15.1
1975	23.6	19.8	17.9	13.0
1976	26.0	24.9	20.5	16.5
1977	29.8	25.3	24.5	17.6
1973-1977	29.4	22.9	22.2	15.5

SOURCE: Computed from Financial Statements, S.E.C. 10K reports

TABLE 3.19

CANADA/U.S. COMPARISON OF MAJOR INDEPENDENT
ORIGINAL EQUIPMENT MOTOR VEHICLE PARTS MANUFACTURERS

CAPITAL EXPENDITURE COMPARISON

Capital Expenditure on Plants and Equipments
as Percent of Sales

	<u>Canadian Operation</u>	<u>U.S. Corporation</u>
1973	4.5	4.7
1974	4.1	4.8
1975	2.0	3.2
1976	2.2	3.3
1977	2.6	3.8
1973-1977	3.0	4.0

SOURCE: Computed from Financial Statements, S.E.C. 10K Reports.

TABLE 3.20

CANADA/U.S. COMPARISON OF MAJOR INDEPENDENT
ORIGINAL EQUIPMENT MOTOR VEHICLE PARTS MANUFACTURERS

REINVESTMENT COMPARISON

Capital Expenditure on Plants and Equipments as
Percent of After Tax Profits, Depreciation and Deferred Taxes

	<u>Canadian Operation</u>	<u>U.S. Corporation</u>
1973	44.1	67.3
1974	44.7	75.7
1975	26.0	52.4
1976	29.6	48.8
1977	31.2	56.9
1973-1977	35.3	59.3

SOURCE: Computed from Financial Statements, S.E.C. 10K reports.

Employment in the Canadian Auto Industry

The measurement of employment in Canada in relation to the total number of North American automotive jobs is a commonly used indicator of the performance of the Canadian automotive industry. Table 9, in the President's Annual Report to Congress, provides data going back to 1964 on U.S. employment prepared by the Bureau of Labor Statistics. The Canadian figures reproduced in Table 10 of the President's Report are drawn from employment figures published by Statistics Canada. These figures indicate that Canada's share of North American auto employment rose from 8.9 per cent in 1965 to more than 11 per cent in recent years.⁶

A paper published by Ontario's Ministry of the Treasury, Economics and Intergovernmental Affairs in May, 1978,⁷ and the submission to the Commission by the UAW, argued that Canada's employment share of the North American market is overstated because the official U.S. figures considerably understate the number of workers involved in automotive components since a number of important categories are excluded from the series.

Our analysis of the employment data of both countries for 1976 indicates that Canadian employment for that year was also

⁶ 12th Annual Report of the President to Congress on the Operation of the Automotive Products Trade Act of 1965.

⁷ Canada's Share of the North American Automotive Industry: An Ontario Perspective.

understated, by some 5,500. With the assistance of the U.S. Department of Commerce, more comprehensive data for U.S. employment was also obtained which brought about an upward adjustment of 183,000 employees. As a result, Canadian automotive employment amounted to around 112,000, and U.S. employment was approximately 1,034,000 in 1976. The Canadian share of North American automotive employment was, therefore, 9.8 per cent, compared to the 11.2 per cent conventionally presented (see Appendix C).

Table 3.21, which provides annual figures for the industry on this revised basis, shows that in 1964 employment in the Canadian automotive industry totalled 70,600. By 1977, total employment amounted to 117,600.

Although Canada's share of employment in the automotive industry is reasonably high, the employment in Canada is relatively more concentrated in less skilled jobs. Analysis of the employment in all operations of the five largest vehicle manufacturers shows that in 1977 Canadian production employees were involved in more semi-skilled work than their U.S. counterparts, and that less production work was classified as skilled (see Table 3.22). Since 1965, the proportion of skilled production jobs has risen in the U.S., and has fallen marginally in Canada. Another qualitative change in employment has been a shift to a higher proportion of professional type work in the U.S., while the proportion of professionals dropped in Canada.

TABLE 3.21

EMPLOYMENT RELATED TO AUTOMOTIVE
MANUFACTURE IN CANADA 1964 - 1977

- In Thousands -

<u>Calendar Year</u>	<u>Motor Vehicle Assembly (SIC 323)</u>	<u>Truck Body & Trailers (SIC 324)</u>	<u>Automotive Parts & Acc. (SIC 325)</u>	<u>Automobile Fabrics & Acc. (SIC 188)</u>	<u>Total</u>
1964	34.3	4.4	30.5	1.3	70.6
1965	39.8	5.8	35.3	1.9	82.8
1966	40.7	6.3	37.6	2.7	87.3
1967	38.7	6.7	37.7	2.6	85.8
1968	39.6	6.8	37.3	3.1	86.8
1969	42.3	8.2	40.4	4.1	95.0
1970	37.5	8.4	36.4	3.7	86.0
1971	41.0	10.1	41.3	4.3	96.7
1972	41.9	14.2	41.4	5.2	102.7
1973	45.2	14.8	48.8	5.8	114.6
1974	47.1	15.2	45.9	5.7	114.0
1975	43.4	14.4	41.2	4.8	103.8
1976	46.6	14.0	46.2	5.6	112.4
1977*	50.6	12.6	48.6	5.8	117.6

* Preliminary

SOURCE: Statistics Canada, Catalogues 72-002 and 34-222

TABLE 3.22

SKILL DISTRIBUTION OF EMPLOYMENT
IN CANADA AND U.S.A.

- BIG FIVE -

	<u>Canada</u>		<u>U.S.A.</u>	
	<u>1965</u>	<u>1977</u>	<u>1965</u>	<u>1977</u>
Professional	13.4%	12.6%	14.5%	16.5%
Clerical and Sales	9.0%	7.6%	11.6%	7.4%
<u>Production</u>				
Skilled	12.0%	11.8%	13.3%	14.8%
Semi-Skilled	57.4%	58.8%	52.0%	53.0%
Non-Skilled	8.2%	8.8%	8.6%	8.3%
	<hr/>	<hr/>	<hr/>	<hr/>
	100.0%	100.0%	100.0%	100.0%

SOURCE: Estimated from firms' responses to questionnaires of the Inquiry.

Productivity of the Motor Vehicle Manufacturers

As pointed out in the earlier section on the parts sector, there are some difficulties associated with all yardsticks employed to measure productivity.

Traditionally, productivity is measured in one of two ways — as physical output per labour input, or as value-added per labour input. In the Ontario study of the automotive industry referred to earlier, it was concluded by applying a measure based on value, that the productivity of the Canadian vehicle assembly industry was 10 to 15 per cent below that in the United States. As the Canadian Automotive Task Force pointed out in its report last year, however, "the major difficulty of using value-added measures in international comparison of labour productivity is that the result is strongly affected by differences in price structure." Unless these price differences can be isolated, "it would be difficult to use value-added as a realistic basis to measure labour efficiency."⁸ (Indeed, the high degree of intra-company transfer of intermediate and final products across the Canadian-U.S. border casts doubt upon the valuation methods used for productivity comparisons for this industry.)

A more reliable measure of productivity in the two countries, as developed in the Review, can be obtained by measuring the number of vehicles produced in relation to the number

⁸ Review of the North American Automotive Industry; Automotive Task Force, April, 1977; p. 60.

of manhours of production workers. Because there are substantial differences in the size and complexity of various vehicles produced — as between a sub-compact and a truck, for example — it is necessary to adjust for the mix of vehicles produced in each country. This has been done by weighting the output according to the standard number of manhours normally required to produce each type. Engineering data supplied by the manufacturers indicate the number of manhours required to produce each type of vehicle and statistics drawn from Wards' Automotive News made it possible to arrive at an estimate of the mix of vehicle production in each country for each of the years surveyed.

The resulting calculation, shown in Table 3.23, indicates that in every year since 1968, with the exception of 1974, physical productivity of vehicle production in Canada was significantly higher than in the United States. (As also shown in the Table, however, the Canadian advantage is reduced if the number of C.K.D. units is excluded. As noted previously, these units are made up largely of original equipment parts imported from the United States to be packaged in containers for exports to third countries, but in the statistics are counted as vehicles assembled in Canada despite their completely knocked down state.)

TABLE 3.23

PHYSICAL PRODUCTIVITY RATIOS: CANADA/UNITED STATES

MOTOR VEHICLES PER MANHOUR WORKED

	<u>Unweighted Output</u>		<u>Output Weighted for Required Labour Input</u>	
	<u>All Vehicles</u>	<u>Ex C.K.D.</u>	<u>All Vehicles</u>	<u>Ex C.K.D.</u>
1967	.929	--	.896	--
1968	1.224	--	1.170	--
1969	1.167	--	1.217	--
1970	1.218	--	1.094	--
1971*	1.538	--	1.425	--
1972	1.212	--	1.099	--
1973	1.149	1.110	1.049	1.015
1974	1.065	1.012	.997	.942
1975	1.229	1.153	1.160	1.065
1976	1.289	1.237	1.241	1.152

NOTE: Ratios exceeding 1 indicate Canadian productivity is higher than U.S. productivity

* The high productivity in 1971 in Canada may be explained by a prolonged industrial dispute in both countries.

SOURCE: Estimates based on data from Ward's Automotive News and Census of Manufactures, U.S. Department of Commerce and Statistics Canada. See text for methodology.

Prices, Profits and Investment

The differential in automobile prices between Canada and the United States has, as indicated earlier, long been one of the imperatives governing policies relating to the automotive industry in this country. It was the dominant factor in persuading the government in 1926 to lower tariffs and introduce a Canadian content plan for the first time that allowed for the further reduction of overall duty levels in order to reduce the premium paid by Canadians. The estimated differential in U.S. and Canadian car prices at the retail level of around 35 per cent was an important element in the government decision to launch a comprehensive inquiry into the auto industry by the Tariff Board in 1935. One of the important objectives of the Federal Government in entering the Automotive Agreement with the United States was to bring about a gradual reduction in the continuing high differential in prices of cars in Canada compared with those in the United States.

In 1965, the first year of the Agreement, the difference in the factory price of Canadian and U.S. cars on average - after taking into account the mix of vehicles sold in Canada as compared to the United States - was 16 per cent in nominal dollar terms. That calculation is based on the assumption that the exchange value of the two currencies is identical. Any comparison based on such an assumption is, of course, quite unrealistic. The only element the two currencies have in common is their name. The fact is that only rarely, and then only briefly, are the two

currencies traded on a dollar-for-dollar basis in international exchange markets. While a dollar-for-dollar exchange rate is frequently referred to as par, there is in the real world no such thing as parity between currencies - as recent experience has underlined. The unreality of attempting to equate the two currencies in this way is only accentuated by the prevailing circumstances in which the exchange value of the Canadian dollar is some 15 per cent below that of the U.S. dollar as compared to the "premium" of 3 to 4 cents that existed a few years ago.

As shown in Table 3.24, the differential in average car prices of 16 per cent in 1965 as calculated on a "par" dollar basis, was actually 8 per cent when calculated on the basis of the average exchange value of the Canadian dollar in terms of U.S. currency. At that time, the Canadian exchange rate was still "pegged" at 92½ cents in relation to U.S. currency under the provisions of the International Monetary Fund - meaning that a Canadian dollar could be exchanged for approximately 92½ U.S. cents. The differential in Canadian auto prices compared to those in the U.S. declined gradually from 8 per cent in 1965 to 3.5 per cent in 1970 based on actual exchange rates. The differential climbed to 9.3 per cent in 1971, however, as a result of the unpegging of the Canadian dollar exchange rate in June of 1970 and the subsequently sharp increase in its value in relation to U.S. currency. The differential dropped back to 6.4 per cent in 1975 and 1976. In 1977, average Canadian car prices at the factory level were 1.1 per

TABLE 3.24

CANADA/U.S.A. AVERAGE CAR PRICE DIFFERENTIAL (AT FACTORY COST)

<u>Model Year</u>	<u>On Nominal Dollar Basis</u>	<u>On Exchange-Adjusted Basis</u>
1965	16.0%	8.0%
1966	13.0	5.0
1967	12.0	4.0
1968	12.0	4.0
1969	11.8	3.8
1970	11.5	3.5
1971	10.3	9.3
1972	9.6	8.5
1973	9.6	9.6
1974	7.7	9.3
1975	6.5	6.4
1976	6.5	6.4
1977	9.3	-1.1
1978*	9.4	-1.4

*preliminary

SOURCE: Department of Industry, Trade and Commerce

cent below those in the United States and by 1978 the Canadian average was around 1.4 per cent lower than the average U.S. price.

In nominal dollar terms, Canadian automobile prices at the factory level remain above those in the United States. At the retail level, they are higher still because of the impact of federal and provincial sales taxes and several other factors, including somewhat higher distribution and warrant costs. The real question, however, is what is the comparable cost of buying a car elsewhere? If a Canadian were able to import an automobile duty-free from the United States, it would be more expensive than acquiring a similar car in Canada at the current value of Canadian funds in relation to U.S. currency.

As noted earlier, the U.S. Treasury Department in 1975 launched an investigation into allegations that vehicles from Canada, along with those from a number of other countries, were being dumped in the United States. In tentatively discontinuing the inquiry in 1976, the Treasury indicated it was satisfied that Canadian vehicles were being sold in the United States at less than the prices charged at a comparable level in the Canadian distribution chain. In the notice it filed in the Federal Register of May 17, 1976,⁹ the Department of the Treasury noted that in 1965, there were substantial price differentials between Canada and the United States for automobiles. Since that time, there had been a steady and

⁹ Federal Register, 41 F.R. 20189; May 17, 1976.

significant decline in the differential at the wholesale level due to the Agreement and this trend was expected to continue, the Treasury said. Each of the major vehicle manufacturers subsequently filed undertakings with the Department promising that "efforts will be made to improve the efficiencies permissible under the Automotive Agreement, such that the trend toward elimination of these price differentials will continue to occur in the future."

The automobile manufacturers have argued that while production costs in Canada are now comparable to those in the United States as a result of the rationalization process underway since 1965, there are other costs of doing business which brings the total to a level of three to four per cent higher than that prevailing south of the border. These included higher costs of retailing, fulfillment of warranty obligations, and transportation.

Until recent years, it would appear the differential between Canadian and U.S. prices has been significantly above the level that could be explained by the manufacturers' contentions with respect to cost differentials. Some Canadian automotive executives have insisted that this differential was necessary to maintain a healthy profit performance, which in turn was required to justify what their parent companies perceived as additional risks of investing in Canada. This is an issue that will be explored further in a subsequent chapter in light of the fact that the return on investment of the motor vehicle manufacturers in Canada has consistently exceeded that on their operations overseas, which

suggests that other factors may be at work. It is apparent that the question needs to be examined against the background of developments in the past few years, during which car prices in Canada have been marginally below those in the United States on an exchange-adjusted basis.

Throughout most of the 1970s, the profits of the major motor vehicle manufacturers in Canada have been above those of their U.S. parent companies and at least earlier in the decade were well above those of their overseas affiliates.

Table 3.25 provides a comparison of the annual return on assets of the Big Four vehicle manufacturing companies in Canada compared to that of their U.S. parent companies from 1965 to 1977. It indicates that, as a group, the profits of the Canadian companies have significantly exceeded those of the U.S. companies in every year from 1971 to 1975. The differential became marginal in 1976 and in 1977 the return on assets by the Canadian firms was 2.8 percentage points below that in the United States. A similar trend is also evident from the figures in Table 3.26 for individual companies. This shift in the relative position of Canadian producers over the past few years may be due to a number of factors, including the impact of the Anti-Inflation Board, competition, and the decline in the exchange-adjusted differential in auto prices.

Some indication of the relative profitability by a variety of different yardsticks of Canadian vehicle manufacturers compared with those overseas, including affiliates of U.S. companies, earlier in the 1970's is illustrated by Table 3.27.

TABLE 3.25

RETURN ON ASSETS OF THE BIG FOUR

(NET PROFIT/TOTAL ASSETS)

	(a) <u>CANADA</u>	(b) <u>U.S.A.</u>
1965	8.2%	13.7%
1966	4.2	10.8
1967	5.8	7.2
1968	8.1	9.6
1969	9.2	8.1
1970	3.2	3.6
1971	10.0	7.8
1972	12.0	9.1
1973	12.0	9.1
1974	9.9	3.0
1975	7.9	3.0
1976	9.4	8.8
1977	6.7	9.5

SOURCE: Column (a) computed from data provided by Statistics Canada;
 Column (b) computed from firms' financial reports.

TABLE 3.26

NET INCOME AFTER TAX AS PERCENT OF TOTAL ASSETS

<u>Year</u>	<u>General Motors</u>		<u>Ford</u>		<u>Chrysler</u>	
	<u>Total Corp.</u>	<u>Canada</u>	<u>Total Corp.</u>	<u>Canada</u>	<u>Total Corp.</u>	<u>Canada</u>
1970	4.3	(3.6)	5.2	7.8	(0.2)	7.8
1971	10.6	11.3	6.3	7.7	1.7	6.9
1972	11.8	12.0	7.5	9.2	4.0	10.1
1973	11.8	12.4	7.0	10.4	4.2	7.3
1974	4.6	9.7	2.5	10.6	(0.8)	3.6
1975	5.8	10.4	2.3	7.5	(4.1)	3.2
1976	11.9	10.0	6.2	7.6	6.0	5.9
1977	12.4	12.3	8.7	1.9	2.1	1.2

AVERAGE

1971-73	11.4	11.9	6.9	9.1	3.3	8.1
1974-77	8.7	10.6	4.9	6.9	0.8	3.5
1971-77	9.8	11.2	5.8	7.8	1.9	5.5

SOURCE: Calculated from Financial Statements.

COMPARISON OF MOTOR VEHICLE MANUFACTURERS' PROFITABILITY

(AVERAGE 1970 - 1973)

<u>Return on Shareholder's Equity¹</u> (percent)	<u>Return on Capital Invested²</u> (percent)	<u>Return on Trading Assets³</u> (percent)	
G.M. Canada*	23.8	G.M. Canada*	80.8
Opel	19.1	Ford Canada	52.3
Peugeot	18.4	Opel	39.3
Ford-Werke	17.9	Chrysler Canada	37.4
G.M. Canada	17.0	Daimler-Benz	37.4
Ford Canada	16.8	G.M. Canada	35.3
Nissan-Datsun	15.5	Ford-Werke	31.8
Toyota	15.4	Peugeot	30.7
Volvo	15.0	Fiat	30.5
Chrysler Canada	14.1	BMW	30.4
Daimler-Benz	11.6	Volvo	26.6
Simca	7.2	Volkswagen	23.1
Ford U.K.	5.9	Ford U.K.	21.6
British Leyland	5.6	Nissan-Datsun	21.2
Volkswagen	4.2	British Leyland	19.6
Fiat	(-1.5)	Volvo	19.1
Renault	(-3.6)	Simca	18.6
Citroen	(-5.5)	Vauxhall	13.7
Vauxhall	(-8.4)	Renault	12.9
Chrysler U.K.	(-9.6)	Citroen	12.1*
		Chrysler U.K.	8.1

NOTE: "G.M. Canada*" relates to operation for the duration of 1971 - 1973 as compared to "G.M. Canada" which relates to operation 1970 - 1973. In 1970, G.M. Canada suffered from loss of income partly due to industrial dispute.

1 This is defined as profits after interest and tax divided by shareholders' investment in the company.

2 Defined as profits before interest and tax on the total capital employed in the business.

3 Defined as trading profit before interest and tax plus depreciation divided by net assets less cash, bank deposits, and trade investments.

SOURCE: Company financial reports

The "lumpiness" of capital expenditures on new plant and equipment makes it difficult to undertake meaningful comparisons in individual years. The data in Table 3.28 points out the relatively low level of capital investment by the major vehicle manufacturers in Canada during the years 1960 to 1964 in relation to the North American total. Even at that, investment was comparatively high in relation to Canada's share of production. Between 1965 and 1967, the proportion of investment increased sharply, reflecting the upsurge initially following the adoption of the extended remission plan in 1963 and reinforced by the conclusion of the Automotive Agreement in 1965. The ratio dropped subsequently to 4.3 per cent between 1971 and 1973 and then climbed back again to 6.6 per cent between 1974 and 1977. The average ratio over the period from 1965 to 1977 was 6.5 per cent.

Another perspective on the pattern of capital investment in the two countries is provided in Table 3.29 which shows the relationship of net fixed assets associated with the output of products under the Canada-U.S. Agreement.

Tables 3.30 and 3.31 provide a picture of the earnings retained by the major companies in Canada, the inflows of capital from U.S. affiliates to finance net direct investment in this country, and the subsequent repayment of loans, and the outflow of earnings in the form of dividends to the parent companies.

TABLE 3.28

NET DIRECT INVESTMENT EXPENDITURES ON PLANT AND EQUIPMENT
FOR THE PRODUCTION OF MOTOR VEHICLE PRODUCTS RELATED TO APTA

- BIG FIVE -

	<u>Canada</u>	<u>U.S.A.</u>	<u>Canada as % of Canada and U.S.A.</u>
	- CDN \$Millions -		
1960-64	c	c	4.9
1965-67	404.0	4180.1	8.8
1968-70	283.0	4269.3	6.2
1971-73	192.4	4254.1	4.3
1974-77	508.3	7179.0	6.6
- - - -	- - - -	- - - -	- -
1965-77	1387.7	19882.5	6.5

c - Not disclosed to meet confidentiality requirements.

Source: Compiled from firms' responses to questionnaires of
the Inquiry

TABLE 3.29

BOOK VALUE OF NET FIXED ASSETS IN MANUFACTURE
OF PRODUCTS RELATED TO APTA, IN CANADA AND U.S.A.

- BIG FIVE -

	<u>Canada</u>	<u>U.S.A.</u>	<u>Canada as % of Canada & U.S.A.</u>
	- CDN \$Millions -		
1960	181.3	4,079.2	4.3
1961	182.6	4,035.3	4.3
1962	186.6	4,065.3	4.4
1963	210.5	4,228.8	4.7
1964	291.3	4,848.6	5.7
1965	398.5	5,790.1	6.4
1966	481.5	6,463.4	6.9
1967	520.4	6,795.0	7.1
1968	510.6	6,928.8	6.9
1969	524.3	7,553.7	6.5
1970	568.2	7,623.0	6.9
1971	531.2	7,406.9	6.7
1972	499.1	7,373.6	6.3
1973	517.0	7,894.1	6.1
1974	529.9	8,493.3	5.9
1975	557.6	8,821.6	5.9
1976	556.3	8,519.2	6.1
1977	744.4	10,461.3	6.6

Source: Compiled from firms' responses to questionnaires of
the Inquiry

TABLE 3.30

FINANCING OF NET DIRECT INVESTMENT EXPENDITURES
IN CANADA FOR THE PRODUCTION OF MOTOR VEHICLE PRODUCTS
RELATED TO APTA

- BIG FIVE -

	<u>Retained Earnings From Cdn Operation</u>	<u>Inflow of Capital From Affiliated U.S. Sources*</u>
	- CDN \$Millions -	
1960-64 [†]	117.9	c
1965-67 [†]	174.7	169.1
1968-70	199.2	(31.9)
1971-73	186.8	(77.5)
1974-77	441.3	(5.2)
- - - -	- - - -	- - - -
1965-77	1002.0	54.5

c not disclosed to meet confidentiality requirements

* numbers in brackets indicate repayment of loans

[†] 1960-63 excludes Ford and Chrysler; 1960-67 excludes Chrysler

Source: Compiled from firms' responses to questionnaire of
the Inquiry

TABLE 3.31

NET INVESTMENT INCOME FLOWS

DERIVED FROM OPERATIONS IN CANADA

- BIG FIVE -

	<u>Income Received by U.S. Parents from Canadian Operation</u>	<u>Income Payments to Canadian Operation by U.S. Parents</u>
	(Cdn. \$ Millions)	
1960-64	135.8	- 0 -
1965-67	179.2	- 0 -
1968-70	93.7	- 0 -
1971-73	320.8	- 0 -
1974-77	557.7	- 0 -
-----	-----	-----
1965-77	1,151.4	- 0 -

SOURCE: Compiled from firms' responses to questionnaires of the Inquiry.

Overseas Automotive Trade

In 1977, imported automobiles from overseas countries captured 20 per cent of total sales in Canada, as compared to 17 per cent in the United States. Some of these automobiles are so-called captive imports - that is, vehicles produced by the overseas affiliates of the Big Three manufacturers in Canada and imported into Canada duty-free under APTA. The great bulk of the imported automotive products, however, are manufactured by unaffiliated foreign companies in Japan, Germany, Italy and France. As pointed out previously, some Canadian parts exports to Canadian affiliates overseas are related to the Automotive Agreement. There is a substantial pass-through of U.S. made parts which are exported in C.K.D. form and classified as Canadian vehicle exports.

While the official statistics reported that Canada had a deficit of \$111 million in 1977, the actual deficit in trade unrelated to APTA amounted to some \$644 million last year. It is probable that both on the global basis measured by Statistics Canada and figures broken down as between trade related and unrelated to the Agreement, the deficit will be very much higher in 1978 - despite the sharp appreciation of foreign currencies. Statistics Canada recently reported that during the first seven months of 1978, the deficit balance in Canada's overseas automotive trade rose to \$226 million - more than three times the deficit recorded during the same period in 1977.

As the first step in a program aimed at the provision of opportunities for Canada to obtain a share of the output of overseas vehicle manufacturers, the Minister of Industry, Trade and Commerce announced in June, 1978, that Canada had negotiated a duty-remission agreement with Volkswagen Canada Ltd.

Under the scheme, the duty on imported Volkswagen automobiles will be reduced to the extent Canadian value-added in any components exported by the company exceeds a threshold level. In the model year 1978-79, the threshold was set at 12 per cent of the total value for duty of all cars imported into Canada by the company during the model year. For the CVA in exports equivalent to the first half of the threshold amount, the remission of duty on imports amounts to 40 per cent of that otherwise payable. On the balance of the threshold amount, the remission is 75 per cent of the duty otherwise payable. To the extent that Canadian value-added in exports exceeds the threshold, imports will earn full remission of duty. The threshold level will be increased from 12 to 18 per cent in the second model year, however, and to 24 per cent in subsequent years. In his announcement, the Minister indicated the government was seeking to work out a similar arrangement with other overseas manufacturers. Issues relating to this program will be further examined in Chapter 7.

The Nature and Structure of the
Canadian Automotive Industry

Although the Canadian automotive industry has long ranked high internationally, and at one time was second in size only to that of the United States, it has remained unique among the major producing nations of the world.

As indicated in Chapter 1, the automobile industry in this country has from its beginning in 1904 operated as a virtual satellite of the U.S. industry — as have many other Canadian industries.

Unlike such countries as the United States, Britain, France, Germany, Italy, Sweden and Japan, Canada has never had a domestically-owned and controlled motor vehicle company that performed all the management, research, development and marketing functions of those major producers abroad. Unlike those industries, all of which are fully integrated operations, the Canadian industry has always been truncated in nature, functioning essentially as a branch of the U.S. industry.

It is sometimes suggested that Canada's capacity to undertake those kinds of functions carried out by a fully-integrated company have been substantially reduced as a result of the Automotive Agreement with the United States. Indeed, it was suggested to this Inquiry that the Agreement had locked the Canadian industry into U.S. technology and eliminated the opportunity for Canada to develop any technological capacity independently.

The fact of the matter is that the Canadian industry has been substantially locked into the American industry technologically, and in almost every other important respect, from the days of its founding. It must be acknowledged that in some areas there has been

a decline in the ability of Canadian companies to function independently as an outcome of the Auto Pact, but the difference is one of degree rather than of kind.

Prior to the Agreement, for example, Canadian head offices of the motor vehicle manufacturers were able to perform somewhat broader management functions. Because of the necessity of governing their operations so as to meet Canadian content and tariff regulations, managers of the subsidiaries operating in this country enjoyed greater freedom than now is the case to make decisions about the procurement of components. For the same reason, they also previously had greater latitude to adapt U.S. production technology to better meet conditions of much smaller-scale production of a great many different models. In addition, they maintained some independent engineering capacity to adapt the models of vehicles produced in Canada so as to respond to content and tariff provisions by the most economic means.

For a number of years prior to the Agreement, for example, some manufacturers produced and sold in Canada cars which bore the same name as similar lines in the United States, but were very different in many important respects than their U.S. counterparts. Sometimes manufacturers in Canada acquired tooling employed by their parents to produce models of a previous year, which they subsequently used to turn out components for current year models in this country - disguised as necessary with distinctive trim or other features. Essentially, however, the design, technology and engineering remained basically American in origin.

In respect of the Canadian motor vehicle manufacturers, virtually all original research and development has in the past and continues in the present to be undertaken by their U.S. parent companies. In 1964, according to Statistics Canada, the whole of the transportation sector other than the aircraft industry spent only \$1.8 million on research and development. By 1973, expenditures by the whole of the automotive industry in this field amounted to around only \$8 million and it has remained at approximately that level ever since. Furthermore, the greater proportion of those expenditures has been incurred by the parts producers, rather than the vehicle manufacturers.

In its 1977 report, the Canadian Automotive Task Force estimated that Canadian subsidiaries would have contributed at least \$230 million annually to the research and development accounts of their parent companies over the previous six years if charges for such expenditures in relation to sales matched the ratio of R & D costs to sales prevailing in the United States in earlier years. Charges to the Canadian companies may have increased significantly in more recent years in line with the growing research and development expenditures being incurred by U.S. vehicle manufacturers to meet government requirements. A survey published by Business Week in its issue of July 3, 1978, estimated that the United States automotive industry spent nearly \$3.4 billion on research and development in 1977, an increase of some 15 per cent over the previous year.

As a result of the Agreement and the subsequent rationalization of production between the two countries, there has undoubtedly been some decrease in the capacity of Canadian head offices to exercise an independent management function. While they continue to oversee a separate sales organization because of significant differences that exist between Canadian and U.S. markets, decisions about which models will be produced where, when and how are made almost exclusively in the head offices of the U.S. parent companies. Most of the procurement decisions with regard to the whole North American operation are also made in the United States, although General Motors maintains a procurement office in Canada which has some input into home office procurement plans.

In testifying before the Standing Senate Committee on Foreign Affairs in 1976, Carl Beigie, Executive Director of the C.D. Howe Research Institute, said it would be foolish to deny that there were trade-offs involved in the bilateral agreement between Canada and the United States. "In the Auto Pact it happens to be that the independent decision-making that is exercised in Canada in the automotive industry has been reduced, and most sourcing decisions ...have been shifted to Detroit," Mr. Beigie pointed out. "But I must say," he added, "in this particular industry what we have lost is the independence to be inefficient, because that is essentially what we had in the auto industry before the Auto Pact."¹⁰

¹⁰ Proceedings of the Standing Senate Committee on Foreign Affairs, Issue 29, March 25, 1976. P. 29:8.

The main impact of the Agreement was, at most, to reinforce the nature and structure of the Canadian auto industry that has been inherent since its inception, the main characteristic being that of an appendage of the U.S. industry. Subsequent chapters will, however, explore the possibilities that may exist for establishing a greater degree of original automotive research and development in this country, and for developing the managerial, technological and productive capacity to design, manufacture and market an automobile that might be better suited to the kind of driving and weather conditions to be found in Canada.

CHAPTER 4

THE GLOBAL OUTLOOK

Any predictions about the course of future events are hazardous. The hazards are increased many fold in attempting to foretell the future of the global automotive industry, which after decades of gradual evolution is now in the midst of a period of revolutionary change. An attempt to determine what lies ahead cannot be avoided, however, for plans must be made in the present to meet prevailing conditions in the years to come.

While it is quite possible that conditions in the automobile industry will turn out to be quite different than anything currently anticipated, it seems clear that there are at present strong, interacting political and economic forces in play which are rapidly thrusting the industry along a reasonably predictable course.

Led by the United States, governments have imposed increasingly rigorous requirements on the industry to meet fuel consumption, safety and environmental standards which over the next several years will lead to drastic changes in the shape, size and technology of the automobile as we know it today. These developments, in turn, are likely to lead toward a substantial reduction in the number and variety of models, substantially greater

standardization than those that are produced and, hence, to an acceleration of the present trend toward production of an international car for sale in markets around the world.

Undoubtedly, the most far-reaching changes in the North American industry will be those stemming from the fuel economy requirements established by U.S. legislation, which are also affected by other safety and environmental requirements. The former were put into effect following the energy crisis of 1973, the subsequent sharp increase in petroleum prices which added heavily both to consumer costs and the burden on the U.S. balance of international payments, and warnings from many experts that the world faced the danger of a growing shortage of petroleum well before the end of the present century.

Canada and the United States have established common targets which require that the fleet of automobiles sold by a manufacturer achieve a rated-average of 24 miles per Imperial gallon by 1980 and 33 miles per gallon by 1985. By contrast, the fleet average in 1975 for combined city and country driving was an estimated 18.3 miles per gallon in Canada and 18.7 miles per gallon in the United States. In the United States, failure to meet the target laid down by Congress can result in a penalty of \$5.00 times the number of vehicles sold for every one-tenth of a mile by which the fleet average falls below the required mileage per gallon.

The implications of these requirements, and perhaps even more rigorous standards to be established after 1985, are far-reaching.

General Motors, for example, has estimated that in order to meet the standards set for 1985, around 85 per cent of all the cars it sells in that year can be no heavier than its current sub-compact model, the Chevrolet Vega. Given the vagaries of consumer preferences, it is clear that the auto manufacturers will be faced with major unknown quantities in trying to achieve a mix of vehicle sales that will enable it to meet fleet mileage requirements.

While the United States Congress has frequently indicated its lack of enthusiasm for Canada's automotive content provisions, it is worth noting that Congress itself has adapted the fleet mileage provisions to establish a content provision of its own. In response to pressure from the United Auto Workers for increased protection against the captive imports of vehicles produced by U.S. manufacturers overseas, Congress provided under the Energy Policy and Conservation Act that in order to be included in the fleet mileage calculation, automobiles imported from overseas and sold by U.S. manufacturers after 1979 must have a North American content of at least 75 per cent.

As a step toward meeting the fuel consumption standards laid down in both Canada and the United States, a substantial number of models have already been reduced significantly in size and their weight trimmed down by as much as 700 to 1,000 pounds. It is apparent, however, that in order to meet the targets, further significant reductions will be required in the average size of vehicles. In addition, it is expected that substantially greater

use will be made of light-weight aluminum, high strength-low alloy steels, plastic and other materials.

It has been estimated, for example, that by 1980 the amount of aluminum in the average vehicle will have increased from the present level of around 100 pounds to 200 pounds, replacing more than 500 pounds of steel now employed for such purposes as bumpers, floors and hoods.

Beyond 1980, it is anticipated that further major gains in fuel economy will come not only from continuing changes in the size and structure of the automobile, but also through improvements in engine efficiency and reduced horsepower, adoption of four-speed manual or automatic transmissions, better ignition and carburetor systems and new designs that reduce wind resistance. The 1976 U.S. report by the Federal Task Force on Motor Vehicle Goals beyond 1980 calculated that through adoption of various measures that it outlined, consumption of fuel by 1995 could be from 40 to 50 per cent below the level anticipated if the average fleet mileage remained the same as it was for 1975 models. It would also be about 26 per cent below the actual level of fuel consumption in 1976, which was the equivalent of just over 5 million barrels of petroleum daily.

There are, however, a number of uncertainties that cloud the future course of events. There is frequently a close and sometimes conflicting relationship between fuel requirements on one hand and environmental and safety requirements on the other. Between 1965 and 1974, it is estimated that the weight of the average compact

increased by 310 pounds and that all but 26 pounds was the result of new safety provisions that manufacturers were directed to incorporate in their vehicles. The diesel engine offers substantial promise in achieving significant gains in fuel economy and creates few environmental problems. It is open to question, however, whether it would be possible at any reasonable cost to reduce nitrogen oxide emissions to the level currently being considered in the United States. The imposition of more rigorous environmental standards could also work against the fuel economy of other engines. Farther over the horizon is the possibility of new continuous combustion engines coming into service that are cleaner and more efficient than any in use today. A long period of further technological development is required, however, before they might become a practical alternative.

To a considerable extent, the Canadian automotive industry — as an integral part of the North American industry — will be locked into the pattern south of the border. There may, however, be room for some differences in approach. Canada, for example, parted company with the United States with respect to the emission standards established by the latter in 1975. In that year, air pollution from automobiles sold in both Canada and the United States was some 70 per cent below the level prevailing in 1965. Under the Clean Air Act of 1970, Congress required that emissions from automobiles sold in the United States be reduced by 90 per cent below 1965 levels by 1981. Canadian authorities decided against following the U.S. lead beyond 1975 because they considered that the environmental problem was less

severe in this country than the United States, that the available technology was costly and unproven, and that it would result in a significant reduction in fuel efficiency.

Canadian safety regulations also departed significantly from those that went into effect with the 1974 models in the United States, which required installation of an ignition-interlock system under which seat belts had to be buckled up before the engine would start. A wave of public protest subsequently led to the withdrawal of this requirement. Similarly, Canada has not adopted the U.S. requirement that all cars sold there — beginning with the 1982 model year for larger vehicles and 1984 for smaller ones — come equipped with passive restraints. These could include air bags or automatic lap and shoulder restraints. Canadian authorities rejected this course because they consider them not only costly — particularly in the case of the air bag — but also less effective in most circumstances than the present manually-attached seat belts. In the absence of any mandatory requirements for the use of such seat belts, it is estimated that only some 15 per cent of U.S. drivers employ them voluntarily. Due to the spread of provincial laws requiring the use of seat belts, it is estimated that they are now employed by some 50 per cent of all Canadian drivers and it is expected that proportion will rise to 80 per cent within the next few years.

Some Canadian observers believe that so long as Canadian environmental requirements remain below those in the United States,

Canada has an opportunity to develop a rather different type of engine than those being planned by the major motor vehicle manufacturers. They envision such an engine as being better adapted to the winter driving conditions in this country, thus significantly reducing the additional amount of fuel consumed by existing types of engines when the weather is cold. Whether that is a practical alternative, however, still remains very much an open question.

A decade or so ago, there were two basic types of automobiles — the American car and the European car. U.S. companies produced a number of different models of cars in a number of European countries, but they were all of the European type. Increasingly, however, manufacturers in Europe, Japan and the United States have been moving toward the production of cars of similar size, style and design, and incorporating many similarities in structure and engineering. This trend toward a "world car", and one whose main features have been pioneered to a considerable extent by overseas manufacturers, was probably inevitable. But there seems no doubt that the pace has been quickened by the multiplicity of new safety, environmental and fuel efficiency requirements imposed by the United States and other countries, which in turn has compelled manufacturers to seek larger scale production of a more limited number of models in order to meet the substantial increase in costs resulting from these regulations.

The world car is already a reality. The Kadett, first developed and produced by General Motors' subsidiary in West Germany,

is now sold in North America as the Chevette and the basic model produced in six different countries. Ford's Fiesta was first produced in Spain in 1976. It is now produced in Germany and Britain. It may also be produced in the future in the United States, where it is currently being imported from overseas, because of the North American content regulations associated with fleet mileage requirements referred to earlier.

Associated with the development of the world car is another recent phenomenon - complementation - a term that is used to describe the process by which automotive components are built in one country for assembly in vehicles in one or more other countries. In this sense, there is a high degree of complementation within the North American industry, but the process is also considerably more international in scope. As an illustration, the publication for the first quarter of 1968 of the Economist Intelligence Unit, observed: "The likely trend is already traceable in the Ford Mustang*, which is built in Canada with a Brazilian engine and a French transmission but is listed, for statistics purposes, as a domestic car."

The introduction of the world car and the process of complementation, particularly as it involves some of the less-developed countries, has been seen as a threat in some quarters both in the United States and Canada. While the course of future developments is particularly difficult to anticipate, North America has, in fact, become increasingly competitive with overseas automotive producers as a result of the drastic appreciation that

* The Ford model actually built in Canada employing these foreign components is the Pinto.

that has taken place in foreign currencies over the past few years. Volkswagen has already begun assembly in a plant in Pennsylvania and it may not be too many years before other overseas producers follow suit.

In its issue of September 23, 1978, the Economist Magazine reported: "The cheap imported Japanese car is dead. A revolution is underway at Japanese car companies. By the mid-1980s Japan's car makers will be out of high-volume, low-margin exports and into lower-volume, higher profit models - more like BMWs or Mercedes than today's Datsuns or Toyotas. Parts of the Japanese motor industry will be dismantled and shifted abroad, where labour costs (even in America) are now lower."

Part of the concern with respect to complementation has been associated with imports of automotive products into Canada from developing countries. In 1977, however, such imports amounted to \$61 million, which accounted for only 0.5 per cent of all automotive imports into Canada. Virtually all of these imports from developing countries enter duty free under APTA. Only a very small fraction of imports from these countries enter duty free under the General Preferential Tariff System. It is evident that at the present time that the volume of automotive imports from the developing nations is relatively insignificant.

A more compelling threat in recent years has been that presented by the southern and western regions of the United States, which have increasingly been drawing new automotive investment from

its traditional base in the north-east and north-central regions because of lower wages, land costs and taxes, and because of generous state and local incentives. These new areas have proved extremely attractive as sites for the location of new parts production plants of both the vehicle manufacturers and independent companies. Labour costs have remained significantly below levels prevailing in the northern United States and Central Canada, in large part because of the lower level of unionization. A possible harbinger of change is, however, evident in an agreement accepted by General Motors in September, 1978, under which it will give "preferential consideration" to the employment in its extensive network of southern plants of UAW members now working in GM plants that are already unionized. Rightly or wrongly, the UAW saw this agreement as a means of securing representation in the more than a dozen southern plants either established or proposed by the company over the past several years — only one of which is now unionized.

For North American vehicle manufacturers and parts producers, adjustment to the process of revolutionary change now underway will require heavy expenditures for research, development and investment in new production facilities. It is estimated that for U.S. vehicle manufacturers alone the cost of meeting government-imposed requirements over the period from 1975 to 1985 would vary between \$5 billion and \$15 billion. For some of the smaller companies in particular, these added costs could create serious financial strains — perhaps leading to a growing number of mergers

among existing firms. That the problem is a very real one became evident earlier in 1978 when Chrysler Corporation found itself compelled to sell its very substantial operations in Britain and Continental Europe to the French company, P.S.A. Peugeot-Citroën, to raise cash to finance a major new investment program at home.

For Canada, the rapidly changing environment of the global automotive industry offers significant opportunities and serious challenges. As a country comparatively rich in energy and in many of the mineral resources that will be required to produce the stronger, lighter materials for the car of the future, Canada has the potential to realize significant new market opportunities. But there is equally a danger that we could fall behind if we fail to develop or keep abreast of radically new technologies that emerge both as part of the process of automotive production and as part of the development of more advanced vehicles of the future.

CHAPTER 5

THE CANADIAN AUTOMOTIVE INDUSTRY:

IDENTIFICATION OF THE ISSUES

In the previous chapters, the historical development of the Canadian Automotive industry has been reviewed, and recent events surveyed. From this discussion it is possible to pinpoint a number of key issues concerning the automotive industry. In this chapter, we bring together these concerns and discuss them as a prelude to their analysis and policy responses formulated in the following chapters.

Looking back over the last three-quarters of a century, there are a number of recurring themes such as the high cost of production, high prices for consumers, adverse international trade results, lack of managerial opportunities, and continuing uncertainty about the direction of future industrial developments. The advent of the Auto Pact in 1965 set in train a process of industrial expansion which has gradually moderated the old concerns about efficiency in the industry and the higher prices of vehicles in Canada.

The Auto Pact has also been the mainspring for a great increase in automotive trade within North America. Both Canada and the U.S.A. have been made better off by this enlargement of trade. In any particular year, one side or the other may feel that its opposite number has gained most from the Pact. This is because the

overall trade occurring under the Auto Pact has never been precisely in balance. Yet as previously noted these deviations from balance have always been a very minor proportion of the value of total trade. Outside the terms of the Auto Pact, however, Canada has continued to pile up chronic deficits which clearly point to serious problems in certain sectors of the automotive industry.

Foreign ownership of most of the Canadian automotive assembly industry, and a large proportion of the parts industry, has led to an allocation of functions between head offices and local Canadian operations which has not been to Canada's advantage. Opportunities for job enrichment and the development of managerial and research talents have been rare as a consequence of this pattern of foreign ownership.

Important indications of the nature and extent of the problem areas in Canada's automotive industry can be identified by an examination of the balance of payments in automotive trade. Key issues which require examination, analysis, and resolution emerge from a discussion of the automotive industry's current account results.

In world-wide automotive trade, Canada incurred a deficit on current account of about \$1.8 billion in 1977. This deficit has consistently exceeded \$1 billion in each year since 1973. Although it has fluctuated somewhat, the underlying trend throughout the 1970s has been toward an increase in the magnitude of the deficit.

The size and persistence of this overall deficit is deeply disturbing. These adverse results raise crucial questions about the degree of international competitiveness of certain segments of Canada's automotive industry. There are serious problems related to various aspects of industrial efficiency, market penetration, head office activities, and technological deficiencies.

The nature of these difficulties can be identified through an examination of the important elements which contribute to the overall current account deficit. It is immediately noticeable that the deficit in the main can be traced to trade and dealings which are not covered by the terms of the Auto Pact. The principal sources of recent current account deficits can be listed as follows:

1. The extensive trade, not covered by the Auto Pact, which Canada conducts with overseas nations.
2. The deficit arising from trade in aftermarket parts within North America.
3. Canadian payments for the rights to use new technology, processes and products arising from parent R & D expenditures.
4. Canadian payments for the use of tooling, engineering and management services.

Each of these important elements in the automotive current account will be discussed briefly in turn.

1. Non Auto Pact Trade with Third Countries

These transactions resulted in a 1977 deficit of \$643 million for Canada. Total non-APTA imports from third countries amounted to \$767 million in 1977, of which vehicles accounted for \$563 million, tires \$110 million, and automotive parts were valued at \$94 million. Canada's non-APTA overseas exports totalled only \$123 million, of which \$67 million was vehicles, \$49 million was in the form of parts, and the rest were tires.

Clearly it is imports of cars and trucks which constitute the lion's share of this trade. These vehicles are produced by major automotive manufacturers in Japan and Europe, who are not affiliated with the large U.S. auto producers. Canada has sold only miniscule quantities of original equipment and aftermarket parts to these overseas manufacturers. The general duty remission program available to automotive importers has not had the desired impact on parts exports partly because it limits the value of the credit to the value of equivalent parts on vehicles imported into Canada. This helps to explain why non-APTA parts sales to overseas buyers have risen by only \$25 million between 1970 and 1977.

The issue that emerges from this discussion is the need to find ways by which Canada can expand overseas exports, particularly of parts, to offset the continuing deficits in this trade. This issue is analyzed in Chapter 7.

2. Aftermarket Parts Trade in North America

This extensive trade is not covered by the terms of the Auto Pact. Trade within North America of aftermarket parts has now reached major proportions. Of the over one-half billion dollar deficit in Canada's non-APTA trade with the U.S.A. in 1977, some \$380 million was contributed by the deficit in aftermarket parts. The lopsidedness of these transactions is clear from the trade flows. Canada imported about \$490 million, but this was offset by aftermarket parts exports to the U.S.A. of just \$110 million in 1977.

The bulk of the Canadian aftermarket parts industry is protected by duties ranging from 12.5 to 17.5 percent tariff, and generally faces a 4 percent tariff on the U.S. side. The relatively high Canadian rates of duty have not appeared to stem the flow of imports into Canada, but the low American tariff seems to have impaired Canada's ability to penetrate the U.S. market.

It is important that the Canadian aftermarket parts industry improve its international competitiveness, if balanced development is to be achieved in the overall Canadian parts producing sector. This issue is discussed in Chapter 7.

3. Payments to Head Offices for the Benefits from American/
Research and Development Work

It has been estimated that in 1977 revenues from Canadian subsidiaries of the major U.S. automotive manufacturers contributed as much as \$375 million towards the head office R & D budget.¹ Expenditure on R & D in Canada by these corporations was at the same time less than \$5 million.

While Canadian branch plants obviously benefit from American R & D activities, which result in more efficient production processes and lighter, safer, less-polluting vehicles, there is an overwhelming imbalance against Canadian participation in these activities. The poverty of R & D automotive expenditures in Canada is an issue which is examined in Chapter 8.

4. Payments to Head Offices for Tooling, Engineering and
Management Services

Canadian subsidiaries of the major U.S. motor vehicle manufacturers paid their parents \$386 million for services of this nature in 1977. The record of such charges levied since 1964 is shown in Table 5.1.

¹ The \$375 million is an estimate, built up from three types of payments. First, direct payments by Canadian subsidiaries to their parents, which were some \$230 million in 1977. Second, that amount of the charge on finished vehicles imported from the U.S.A. which represents the amortization of U.S. R & D expenditures. Third, payments for some direct research services rendered to the Canadian subsidiaries by their parents. There may be a slight overlap between these last amounts and those recorded as payments for tooling, engineering and management services. The data are not available to allow a more precise attribution of these costs.

TABLE 5.1

IMPORTS FROM U.S.A. OF PRODUCTION MACHINERY AND EQUIPMENT
AND THE TRANSFER OF MISCELLANEOUS SERVICES FROM THE
UNITED STATES TO CANADA

- BIG FOUR -

(in Cdn \$ Millions)

<u>Year</u>	<u>Production Machinery and Equipment</u>	<u>Tooling, Engineering & Management Charges</u>	<u>Total Import of Production Machinery and Service Charges</u>
	(a)	(b)	(c)
1964	45.7	50.7	96.4
1965	47.8	45.6	93.4
1966	72.2	84.7	156.9
1967	65.0	105.3	170.3
1968	73.6	92.1	165.7
1969	19.5	129.8	149.3
1970	55.6	140.6	196.2
1971	20.6	108.9	129.5
1972	13.6	135.0	148.6
1973	21.4	212.7	234.0
1974	32.3	264.4	296.7
1975	23.7	306.7	330.4
1976	30.2	393.4	423.6
1977	60.1	386.0	446.1

SOURCE: Compiled from firms' responses to questionnaires of the
Commission

Tooling costs are for re-equipping in-house parts plants and assembly lines with dies, tools, and other equipment needed to turn out new model lines. Canadian subsidiaries also pay engineering fees for the redesign, installation and testing of the revamped assembly lines. Management assistance in the form of such activities as financial planning, production analysis and inventory control is obtained from head offices in Detroit.

The charges are an indicator of the truncation of head office activities in Canadian branch plants. Paucity of opportunities for professional employment in the Canadian automotive industry is discussed in Chapter 8.

The foregoing sources of current account automotive deficit arise from problems within various sub-sectors of the automotive industry. These trading results highlight the important point that the sources of the largest contributions to Canada's deficits come from trade and industrial payments which are not covered by the Auto Pact. There have been swings from deficit to surplus and back to deficit in the overall Auto Pact merchandise trade results. The extent of the deficit or surplus has never exceeded one tenth of total two-way trade under the Pact, and these variations can be readily understood. In large measure, they are the result of cyclical deviations between Canada and the U.S.A. in the pattern and strength of consumer demand, the mix of final products, and relative costs of production.

Only in the early years of the Agreement did Canada encounter sizeable trade deficits with respect to sales within North America of independently manufactured OEM parts. Table 3.13 shows that since 1970 the sourcing of this type of Canadian parts by the Big Five in the U.S.A. has far exceeded the sourcing of American made parts by the Big Five in Canada.

If there is an issue related to parts sourcing, then it arises from Canada's lack of facilities to produce in-house OEM automotive parts. Although our production of these high value-added commodities has risen rapidly in the last decade, the deficit shown in Table 3.13 indicates that there is still scope for considerable development of expanded production. In Chapter 6, the discussion is addressed to this issue.

There are two other areas of concern which give rise to issues not directly connected with the balance of payments.

The first concern is the question of the continuing differential, before taxes, between prices of new vehicles at the distributors' gate in Canada and the U.S.A. Over the life of the Pact this price differential has gradually declined. At the present time it has virtually disappeared but this results from recent exchange rate adjustments and may be only a temporary phenomenon. In any event, the price differential remains an important issue for Canadians and will be discussed in Chapter 6.

The second concern is about the regional distribution of industrial activity in the automotive industry in Canada. For reasons of proximity to Detroit and the siting of the McLaughlin

plant in Oshawa, Ontario has always hosted a very high proportion of Canada's assembly plants. Around these installations have gathered many of the automotive parts producers. Does the future development of the Canadian automotive industry have to retain this pattern of spatial concentration or are there reasons to expect that this industry may become more widely dispersed around the country? This issue is addressed in Chapter 9.

The central issues identified in this chapter as being of concern to the Canadian automotive sector suggest the following objectives, which will be discussed in detail in subsequent chapters.

1. The expansion of Canada's exports of OEM and aftermarket parts to automotive manufacturers in third countries.

2. The upgrading of the international competitiveness of the Canadian aftermarket parts sector.

3. An increase in automotive related R & D spending within Canada to complement R & D work in the U.S.A.

4. The development of domestic expertise as an alternative to the extensive purchase of technical and managerial services from the head offices of U.S. automotive manufacturers.

5. An expansion of Canadian in-house parts production capacity.

6. The attainment of a reasonable relationship between vehicle prices in Canada and the U.S.A.

7. An improvement in the regional distribution of automotive activity.

This Report now proceeds to analyze and comment on these objectives in the following chapters. Some proposals for dealing with both specific and general problems are outlined. Since the central issues to a large extent revolve about the need to improve the international competitiveness of several sub-sectors of the automotive industry, this implies an emphasis on upgrading, refurbishing and expanding existing production capacities. Therefore, the next two chapters are concerned with the outlook for investments which will allow the Canadian automotive industry to achieve further productivity gains and scale benefits. There follow separate chapters on research and development, regional industrial location, and the option of producing a Canadian car.

CHAPTER 6

OUTLOOK FOR INVESTMENT IN THE CANADIAN AUTOMOTIVE ASSEMBLY AND IN-HOUSE PARTS INDUSTRY

The Record of Investment in Assembly and Captive Parts Facilities

The period of most rapid increase in the rate of investment flows into the Canadian automotive industry occurred between 1965 and 1967. Some \$400 million was invested by the Big Five in this period, and Canada received almost one-eleventh of the total North American investment by this group.

This surge in activity was in response to the rationalization and specialization opportunities offered and required¹ by the Auto Pact. The rate of investment gradually eased off until in the three year period 1971-73 it registered some \$190 million. Over the whole period the Auto Pact has been in existence, namely 1965 to 1977, the Big Five invested almost \$1.4 billion. This is an amount that represents 6.5 per cent of the total North American automotive net capital formation by the Big Five.

¹ The automobile producers gave separate undertakings to the Canadian government that they would meet certain investment targets in the early years of the Auto Pact.

The Value of the Automotive Industry's Assets

The peak Canadian share of total North American net fixed assets at book value was recorded as 7.1 per cent in 1967. At that time these Canadian located net fixed assets were valued at \$520 million. There was very little advance in the value of this stock of capital between 1967 and 1976. Indeed the lowest share of Canadian to total North American automotive capital equipment owned by the Big Five was recorded in 1975. A spurt in investment in 1977 revived this ratio to 6.6 per cent and increased the net book value of Canadian net fixed assets to almost \$750 million.

To summarize the investment record of the Big Five in Canada:

- (1) There was a flurry of investment activity between 1964 and 1967, which caused the net value of fixed assets to increase by about 45 per cent.
- (2) As we shall see, these new capital expenditures gradually led to significant increases in the productivity of the Canadian automobile assembly industry.
- (3) From 1967 to 1976, the book value of net fixed assets used in the manufacture of automobiles by the Big Five rose by only \$36 million to reach \$556 million. Thus net additions to the Canadian capital stock in the

automotive assembly industry were relatively minor over a period of ten years.

- (4) It should be remembered that the foregoing data were reported in current or nominal dollars. It is obvious that the use of a correctly deflated capital stock series² would show an actual decline in the real book value of Canadian net fixed assets used in the manufacture of products related to the Auto Pact.
- (5) There has been a recent revival of investment, dating from 1977. This signals the beginning of a new generation of investment requirements in the automotive industry which has been prompted by the need to "down-size" vehicles, improve economy, curtail pollution, and strengthen the safety features of new models.

² The Commission has not attempted to deflate these capital stock estimates. The development of a theoretically acceptable capital stock deflator involves very difficult conceptual problems which could not be tackled during the short lifetime of this Commission. For a discussion of these problems see T.K. Rymes, Estimates of the Canadian Capital Stock, Volumes I & II, Statistics Canada, Ottawa, 1972.

The interested reader may wish to note that the Canadian GNP implicit price deflator rose by almost 75% between 1967 and 1976, while the nominal book value of the Big Five net fixed assets in Canadian automotive manufacturing rose by just 7% during this period. In the U.S. these assets rose in nominal value by 25%, 1967-76.

Sources of Investment Funds

Since the beginning of the Auto Pact in 1965, the Big Five automotive manufacturers have retained almost exactly \$1 billion of their Canadian earnings for re-investment in this country. On net, there has been a capital inflow from U.S. sources of only \$54.5 million over the last thirteen years (1965 - 1977). Most of the inflows actually occurred in the early investment boom period of 1965-67, and these gross values (\$169 million) were later offset by the repayment of loans (\$115 million) between 1968 and 1976. These loan repayments coincide with the period in which there was a decline in the real value of Canadian net fixed assets used by the Big Five in automotive manufacture.

The Rate of Return on Investment in Automotive Assembly and Captive Parts

It has been noted that \$1 billion of retained earnings was re-invested in the industry by the Big Five between 1965 and 1977. Coincidentally, these producers repatriated to their U.S. parents some \$1.1 billion in net income generated by their Canadian operations.

The adjacent table shows that the Big Four³ in the U.S.A. have recorded double digit rates of return after tax on

³ The Commission was unable to isolate the profitability of motor vehicle manufacturing activities of International Harvester.

shareholder equity in every year from 1960 to 1976, with the exceptions of 1970, 1974 and 1975. While these results have by no means been homogeneous across the Big Four, their group average has consistently outperformed the results for all U.S. manufacturing. Recall that 1970 was a year of industrial disputes, and that the energy crisis of 1973 precipitated the severe slowdown in U.S. industrial activity and especially automotive sales in the following two years.

Having established that the Big Four are consistent high performers by American industrial standards, we may now ask how do their Canadian operations rate? Unfortunately the basis of comparison can no longer be the return on shareholders equity since some Canadian operations are wholly-owned subsidiaries. When net profit is expressed as a proportion of total assets (see Table 3.25), we find it possible to compare the operating results of the Big Four in Canada and the U.S.A. These ratios indicate that between 1965 and 1968 the return on Canadian total assets was below that in the U.S.A. This was during the early years of the Pact when the Canadian asset base was being rapidly expanded by investment, but before the new plants, production lines and systems had been brought on-stream or reached full operational capacity. By the end of the 1960s, the pay-off from these new investments was beginning to show up. With the exception of the strike-affected 1970 model year, the rate of return up to 1976 was strong and always at a higher level than in the U.S.A. Averaging the

TABLE 6.1

AFTER-TAX RETURN ON SHAREHOLDERS' EQUITY:

THE BIG FOUR MOTOR VEHICLE MANUFACTURERS IN U.S.A.

<u>Year</u>	<u>General Motors</u>	<u>Ford</u>	<u>Chrysler</u>	<u>AMC*</u>	<u>Industry Average</u>	<u>All Manufacturing</u>
1960	16.5%	14.9%	4.5%	21.6%	15.2%	13.1%
1961	14.8	13.1	1.5	10.5	13.2	12.8
1962	21.9	14.1	8.4	13.7	18.4	--
1963	22.4	18.0	17.6	13.8	18.9	14.9
1964	22.8	12.6	19.1	9.4	19.1	15.9
1965	25.8	15.7	14.9	2.0	21.0	17.8
1966	20.6	13.0	11.2	- 4.9	16.8	18.3
1967	17.6	1.8	10.9	-42.0	11.6	15.3
1968	17.8	12.7	14.4	6.2	15.7	15.7
1969	16.7	10.5	4.6	2.4	13.3	13.3
1970	6.2	9.4	- 0.4	-27.6	6.0	9.7
1971	18.0	12.5	3.8	2.6	14.2	9.7
1972	18.6	15.3	9.1	6.8	16.0	10.6
1973	19.1	14.8	9.5	13.2	16.4	12.8
1974	7.6	6.0	- 2.0	7.4	5.7	14.9
1975	9.6	3.8	- 8.7	- 7.9	5.8	11.6
1976	20.2	14.4	11.8	-15.5	17.3	13.9
9 months Annual Rate						
1976	19.4	15.5	15.0	1.7	17.5	14.6*
1977	20.3	20.9	9.5	2.2	19.1	14.6**

* Fiscal year ending September 30; nine months' figures are from October to June

** 6 months at annual rates

SOURCE: 1960-1970; calculated from financial statements; United States Internal Revenue Service, "Statistics of Incomes"

1971-1977; U.S. Council on Wage and Price Stability, News Release dated November 14, 1977.

differential rate of return in Canada over the U.S. results between 1970 and 1976 shows Canada ahead by 2.85 per cent annually. Only with the sudden resumption of investment in Canada in 1977 did this differential swing around in favour of the U.S. operations by 2.8 per cent⁴. This result echoes the second half of the 1960's, when Canada experienced the earlier automotive investment upswing by the Big Four.

The excellent profitability of the Big Four Canadian operations⁵ can be traced to a number of sources:

First, it stems from the higher price charged for the final product in Canada. Good results in 1974 and 1975 partially arise from strong sales in Canada, during a period of slow sales in the U.S.A.⁶

Second, it arises from the strong productivity gains achieved in the Canadian assembly industry. This profit performance could scarcely have been achieved with wage parity if productivity had not also surged ahead. The existence of wage parity, while Canadian labour productivity continued to be 10 to 15 per cent

⁴ The effect of the AIB on Canadian profits must also be remembered.

⁵ Within the Big Four group there have of course been excellent results by some companies, and poorer results by others.

⁶ But see also the third argument below.

below that in the U.S.A., on a value added basis, would have precluded high profits. However, the rate of return performance of Canadian installations in the 1970's, ceteris paribus, casts doubt on the received doctrine of "low Canadian labour productivity in automotive assembly". Earlier analysis in Chapter 3 (see Table 3.23) argues convincingly that in assembly operations Canadian labour productivity has matched or exceeded its American counterpart over the past decade. Thus, sustained high output per man hour in volume terms since 1968 has contributed to the excellent record of investment earnings.

Third, the impressive Canadian results in 1974 and 1975 indicate profit ratios more than double those recorded in the U.S.A. This reflects in part the relatively high level of utilisation during these years. Canada was producing the lines of vehicles still exhibiting demand vitality in the North American market during this generally depressed period (compacts and medium-size luxury cars).

There are no reasons to think that the high profitability of Big Four operations in Canada during the 1970's were either accidental or even ephemeral. These results are the fruits of sound investments and balanced managerial decisions. If these investments have been so successful should Canada not expect to see more of the same? Moreover, given the better returns in Canada compared to the U.S.A., should there not be confident expectation

that funds will flow into Canada from U.S. parent companies to complement the normal flow of re-invested Canadian earnings?

The fall in the Canadian dollar relative to the U.S. dollar and other currencies has made land and buildings relatively cheaper to the foreign buyer, while also reducing the relative cost of Canadian labour. Furthermore, the cost of such vital inputs as energy must now appear attractive when compared with U.S. energy costs. These factors are particularly important when considering the likelihood of Canada attracting in the future such energy-using activities as aluminum engine plants, stamping plants, metal refinery operations, and ethylene based extrusions.

The decline in the Canadian dollar will affect the volume of automotive trade undertaken by some U.S. automotive manufacturers. If the volume of their imports into Canada more or less matches the volume of their exports from Canada, then exchange rate losses on sales into Canada are washed out against gains from purchasing from their Canadian subsidiaries. But this balancing act would only occur for a short time, since the U.S. automotive manufacturers would soon recognize the gains to be made from expanding their Canadian production and exports. Providing that the Canadian dollar remains at a significant discount to the U.S. dollar for several years, then Canadian output could expand, net revenues rise, and the rate of return on investment remain strong.

This last point about the rate of return remaining strong is vital, since among other things Canadian dollar

depreciation has for the moment wiped out the price differential between Canadian and American cars. This differential has fallen gradually since the inception of the Auto Pact. But the privileged market position given by the original "designation of manufacturers" under the Pact allowed them to retain a small but important differential through market discrimination. This margin disappeared as a result of exchange rate adjustments in 1977 and 1978, and its disappearance no doubt contributed to the reduction of the profit rate traditionally earned on automotive investments in Canada. The question then becomes will gains from expanded production and exports appear sufficiently profitable with a lower dollar to overcome the immediate loss of the price differential and induce new investment. If these gains do not outweigh the loss of the price differential, then an early reappearance of the differential may be expected.

Barriers to Expanded Investment by North
American Automobile Producers

Once the dust has settled, it appears that the decline in the dollar is not likely to affect adversely the perceived potential rate of return of further Big Four investments. Nevertheless, there are some important issues of political economy which impinge on these crucial capitalization decisions. For the most part, they are vital hurdles in the thicket of "institutional barriers" to investing in Canada. Some of

these impediments are:

- (1) Sovereign risk - the uncertainty of Canadian federal and provincial political stability and the longevity of policy stances;
- (2) The desire by the Big Four to maintain managerial control over production; to ensure that production itself is in close proximity to the major automotive markets in East, Central and Western U.S.A.;
- (3) The prejudice of some American consumers for vehicles "Made in the United States of America";
- (4) The fact that the Auto Pact is only a short term agreement, which at times has seemed quite fragile; it was reported that the Pact came close to being scrapped as part of the Nixon economic measures considered by Secretary Connally in 1971: allegedly was reprieved only at the eleventh hour;
- (5) The risk for the Big Four that not only might the Auto Pact wither or be stricken, but that substantial shifts in U.S. or Canadian commercial policy might occur. In other words, they must always keep in mind the possibility of unexpected tariffs or non-tariff

barriers to parts and vehicles exchanged across the Canada - U.S. border. A change in these laws or rulings could affect the ultimate profitability of the Canadian operations of the Big Four.

Growth in motor vehicle manufacture depends in the foreseeable future on locational decisions to be made by major U.S. automotive producers. This is because Japanese and European automotive manufacturers seem unlikely to extend their assembly operations to Canada.

Policy Measures to Encourage Investment by
North American Automotive Producers

While sovereign risk will always exist because Canada is not the U.S.A., and consequently American investors will always require a rate of return premium for choosing Canada, there are measures which can reduce to a minimum the differential required to compensate for this type of risk. Most obviously, Canada must cultivate an economic environment which once again clearly welcomes foreign capital participation that is in the national interest. Perception and reality may differ greatly in this area, but certainly foreign investors consider that Canada no longer offers the industrial hospitality evident in the mid-1960's. They argue that the operations of FIRA, the conflicts between federal and provincial policy objectives, the record of industrial disputes

in both the private and public sectors, and the failure to achieve any semblance of internal or external economic equilibrium, have all worked against the selection of Canada as a site for expansion of the automotive industry. However to be fair the American companies rate these factors far less detrimentally than do overseas automobile producers. Nevertheless, a politically and economically strong Canada would command a lower risk premium in the board-rooms of prospective investors.

Turning from sovereign risk to the institutional barriers cited in (2) and (3) above, it is obvious that there is little which Canadians can do to change the realities of North American population concentration and consumer tastes. These factors probably tend to limit the extent to which economic rationality and the attractiveness of Canadian locations could determine automotive investment. Yet, in the Commission's view, these constraints are far from binding at present levels.

The ever-present possibility of abrogation of the Auto Pact is an important drawback to future investment planning in the automotive industry. Accepting that all the principal parties on both sides of the border wish to retain the Auto Pact it would be helpful if the Agreement were to be put on a more permanent footing, say for ten or twenty years. In the context of drafting this new Treaty, there are a number of terms and conditions which will

require renegotiation. Even though our American colleagues at this time are focussed on national and international concerns which have distracted their attention from Canada, an opportunity may well arise before very long to proceed with such a project.

A ten year Treaty to cover the decade of the 1980's would give security and continuity to the trade during a vital period of re-investment in the North American automotive industry. As part of this Treaty, a monitoring commission could be established to oversee the workings of the Pact. This commission would undertake annual reviews of trade, employment and investment; it would also suggest regulatory adjustments to encourage an efficient and equitable distribution of activity and employment in the industry. Such a Treaty would go far toward alleviating some of the anxiety about future trade developments on both sides of the border, and might serve as a model for the extension of conditional free trade agreements to other North American industrial sectors.

A complementary policy to enshrining the Auto Pact in a Treaty would involve establishing an insurance scheme to indemnify automotive exporters against damaging changes in U.S. or Canadian commercial policy. This device would cope with the uncertainties discussed in paragraph (5) above. Drawing upon the principle of Export Credit Insurance, the Government of Canada would offer insurance to compensate for export revenue reversals singularly associated with a change in U.S. or Canadian policies.

Compensation should be made available, however, only over a relatively short period of time after a policy shift. In order to ensure that such a scheme is consistent with our international commercial obligations and operated on a sound business footing, potential beneficiaries should be required to buy a policy and be paying premiums prior to any claim. After a realistic period of time, the fund should be reasonably self supporting. If trade disruptions should occur, the Government of Canada would no doubt attempt through both bilateral and multilateral negotiations to alleviate the kind of policy problem covered by this type of insurance.

Investment in Canada by Overseas Automotive Producers

The Commission went to great lengths to discern the attitudes of Japanese and European automotive producers to investment in Canada. There are important perceived barriers to setting up production facilities and entering the North American automotive market from a Canadian base. Not only do overseas manufacturers detail the kind of risks enumerated in the section "Barriers to Expanded Investment by North American Automobile Producers" above, but in common with Canadian and American investors are concerned about the general business environment in Canada. Being further from the scene they are more inclined to exaggerate the importance of management — labour relations and constraints on foreign investment.

Japanese Automotive Producers

The Japanese Big Five are Toyota, Nissan (Datsun), Honda, Mitsubishi and Toyo Kogyo (Mazda), in order of their domestic production. Honda currently leads in exports to Canada with Nissan and Toyota vying for second place. Mitsubishi vehicles are marketed in Canada through Chrysler and include such models as the Arrow and Sapporo. Mazda is currently staging a comeback in Canada after suffering sales reversals connected with the fuel consumption of its rotary engined vehicles.

For the reasons stated above, only the Japanese Big Three can be considered very likely to set up automotive assembly operations in North America. Of this group, Honda alone has taken any obvious steps to build assembly facilities. However, these facilities — in the Columbus, Ohio area — are for motorcycle assembly, although enough land has been accumulated to expand this plant to include automobiles. Honda is nearing peak utilization in Japan (700,000 vehicles) whereas Toyota and Nissan still have ample production capacity. Nevertheless, each of the Japanese Big Three appears to have considered investing in an assembly plant in North America. Are these facilities likely to be built in the next five years and will they be located in Canada? These two questions will be discussed in turn.

Japanese export sales growth to the North American market is becoming increasingly difficult because of Japan's enormous bilateral balance of payments deficit with the U.S.A., and the threat of possible retaliatory U.S. commercial measures. Indeed, a global auto export quota is enforced by Japan's Ministry of International Trade and Industry and this measure is capable of being used to restrict sales to the U.S.A. With their domestic market nearing saturation, Japanese auto producers have looked to new markets in the Mid-East, Africa, Europe, and South America for expansion, but their principal hopes still rest with the abundant North American market. Cost pressures resulting from appreciation of the yen, rising energy costs at home, and a narrowing of the Japan — North America wage gap, together with increased competition among small car producers all argue for careful consideration of North American assembly operations.

There are, however, some important offsets to the advantages of moving to North America. Of these, transportation and distribution expenses seem to be the most overwhelming. Using especially designed roll-on/roll-off vessels, Japanese cars and trucks are transported now to North American ports ranging from Vancouver and Long Beach, California in the West; the Gulf Ports; to New Jersey and the Canadian Maritime terminals in the East. The Commission understands that even with the recent appreciation of the yen and other cost advantages this delivery system results

in landed costs per unit at least \$200 below what could be produced by a Japanese operated North American assembly plant. A large measure of the parts for such a plant would still have to be shipped in knocked-down form from Japan and then hauled overland to assembly points. For the foreseeable future these cost considerations appear so important to Toyota and Nissan that only political pressure could overcome them. If such circumstances prevailed, the choice of an American location would be mandatory.

Looking beyond the next five years, it does appear possible that the Japanese Big Three might choose assembly sites in North America but with the very clear purpose of assuring access to the U.S.A. market⁷. Thus, a scenario of first establishing an assembly plant in the American West, then in the Mid-West, and finally in the East could be possible over a time horizon up to the year 2000. Canada might be able to attract any one of these plants which may be constructed by Japanese automotive manufacturers.

The Commission has concluded, however, that whatever cost advantages in assembly operations Canada can offer Japanese producers, there are very poor prospects in the short run for attracting an assembly plant in Canada. If the initial major assembly investments by Japanese producers were at American

⁷ Note that in 1976 Japan produced 7.8 million vehicles. Of these 3.7 million were exported, including 1.4 million sold in the U.S.A. and 127,779 sold in Canada. About half of the production of Japan's Big Three was exported in 1976.

locations, there could well be a complementary investment in a Canadian parts plant, e.g. aluminum engine blocks and asbestos brake lining facilities. Furthermore, Japanese vehicles assembled in the U.S.A. might become eligible for duty-free entry through the purchase of original equipment parts sourced from Canadian manufacturers. To achieve this objective, the Government of Canada must devise a mix of policies which will not invite U.S. countervailing measures. This will be discussed in the next Chapter.

European Automotive Producers

The Commission's discussions with European automotive manufacturers did not produce any affirmations of interest in locating assembly plants in Canada. Volvo will likely continue their operations at Dartmouth, N.S.; Renault is unlikely to resume their operations in Quebec; there are no new plans by European manufacturers to assemble in Canada. Reasons given more or less mirror those offered by the Japanese. With the exception of Volkswagen and a French joint venture, who are already committed to U.S. locations, there appears to be very little interest in North American assembly. In their discussions with the Commission, European manufacturers took the view that major assembly investment in North America would occur only after market share was sufficient to justify it.

Once again it is parts sourcing, or even investment in a major parts plant, that holds interesting prospects for Canada.

European producers expressed some interest in Canadian locations if they offered competitive skills, fuel costs and raw material sources, and it is conceivable that parts might be fabricated for shipment to European plants. There is already some production and trade of this type in re-manufactured parts.

As discussed in the previous sub-section, Canada will have to develop an imaginative set of policies if a portion of the parts needs of European automotive producers, particularly those which may be U.S. based, is to be supplied from Canadian sources. This problem is examined in greater detail in the next Chapter dealing with the prospects for expansion of the Canadian automotive parts manufacturing industry.

CHAPTER 7

OUTLOOK FOR INVESTMENT IN THE CANADIAN AUTOMOTIVE PARTS INDUSTRY

The Original Equipment Market

Parts are produced in Canada for use in vehicles being assembled here, for vehicles to be assembled in the U.S.A., and for export to assembly plants overseas. When a part is destined to be used in the assembly process, it is termed an Original Equipment part. The market for parts of this kind in North America is relatively oligopsonistic; that is to say, there are few buyers. It is dominated by the Big Four as principal actors with the truck and bus manufacturers in strong supporting roles.

Within the original equipment sector of the Canadian automotive parts industry there are three distinct groups of manufacturers. First, there are the in-house parts producers who actually are owned and operated by one of the assembly companies. For instance, one of the Big Four operates an automatic transmission plant. These in-house parts production facilities are large and use more capital and equipment than do assembly operations. In-house parts production usually involves key automotive items of high value which are produced in long production runs such as stampings, engine blocks, engines, transmissions and drive shafts.

The second group of O.E.M. parts producers is the independent multinational enterprises which can be found on both sides of the border and often in Europe and Asia as well. These companies produce high value-added items such as frames, suspensions, ignitions and a wide range of proprietary products.

Third, is the largest group of firms -- over four hundred -- ranging in size from fewer than ten employees to several hundred, who from their Canadian-based plants sell original equipment parts in North America and to a limited extent overseas. For the most part these Canadian independents turn out parts which involve a fairly low value-added in production using relatively labour-intensive production techniques. However, there are several exceptions to this type-casting, including corporations employing very sophisticated techniques and extremely advanced plants and equipment.

The original equipment parts industry in Canada is then composed of in-house plants of the Big Four, eight independent multinational parts producers, and about four hundred other producers many of which are Canadian-owned. The Big Four in the U.S. have produced from their own plants about 55 per cent of the total annual value of original equipment output over the last decade. In 1977, the U.S. total O.E.M. parts production was worth over \$50 billion. In Canada, the Big Four hold a 40-45 per cent share of the total O.E.M. output of the whole industry which was valued at \$4.4 billion in 1977.

In the previous sections concerned with investment by the automotive manufacturers, we noted that the real book value of their net fixed assets declined between 1968 and 1976 even though they continued nominal flows of investment. Included in those investment flows and capital stock estimates were monies spent by the Big Five not only on assembly facilities, but also on in-house parts plants. Unfortunately, these two streams cannot be unravelled in the data at the disposal of the Commission.

However, it is known that for the industry as a whole relatively more has been invested since 1972 in the parts sector of the automotive industry by all participants than has been invested by the Big Five in assembly alone. Indeed, examination of both Canadian and American data series over longer spans always indicates that the parts' industry has been the target of more investment than the assembly industry. This is not surprising since on average parts production requires more capital per employee, and gives rise to greater value added per man hour than does assembly. There are also grounds for believing that as much as half of the gross annual investment in the parts industry is for upgrading, maintenance and repairs of existing facilities.

Examination of investment flows in the Canadian parts industry reveals that there have been four cycles in these expenditures since 1965. There was an initial surge of new capacity installations between 1965 and 1967. The next wave of expansion came in 1969-70, and then trailed off to 1972. With the continued strength of the Canadian automotive industry in 1974 another peak of new machinery and equipment purchases was reached. After that year, the flow of investment diminished

quite sharply but has been on the upswing once again since 1976. This pattern of surge and ebb in Canadian investment spending since 1967 has not coincided with the even more cyclical record of parts production capacity investment in the U.S.A. Not only does the Canadian industry have a plant and production mix that is quite different from that of the U.S.A., but its record of industrial activity and investment in the last decade has been completely at variance with American experience.

Profitability of the Canadian Automotive Parts and Accessory Manufacturing Industry

Because many of the four hundred odd smaller Canadian parts producing corporations are privately owned, or not publicly quoted, it is not possible to present data on their investment and profit achievements. However, when we examine a cross section of in-house plants, multinationals, and local firm's records drawn from the U.S.A. and Canada, some conclusions concerning overall industrial profitability can be reached. Table 7.1 shows that between 1967 and 1975 the annual average rate of return for automotive parts and accessory manufacturers in the U.S.A. was 9.4 per cent, while in Canada it was 13.2 per cent. These percentages are calculated by expressing profit before taxes as a ratio of net assets. While this ratio has the drawback of not allowing for differential tax rates, it does indicate that Canadian parts operations on average yield a substantially higher rate of return than the same activities in the U.S.A. Indeed, the differential rate of return in Canada's favour is even more evident than in assembly operations.

TABLE 7.1

CANADA/U.S. COMPARISON OF PROFITABILITY
OF AUTOMOTIVE PARTS AND ACCESSORIES MANUFACTURERS

PROFIT BEFORE TAXES AS PERCENT OF NET SALES

<u>Year</u>	U.S.A.	CANADA
	<u>Industry Average</u>	<u>Industry Average</u>
1965	-	11.6
1966	-	6.0
1967	10.8	8.4
1968	11.1	13.9
1969	9.8	14.9
1970	7.9	11.9
1971	10.0	12.4
1972	11.6	16.1
1973	11.1	18.7
1974	7.5	11.8
1975	4.8	11.4

SOURCE: Robert Morris Associates of U.S.A., Statistics Canada
special tabulation

SAMPLE For U.S.A. about 145 financial statements were analyzed.
SIZE: For Canada, industry average applies to 200 firms.

Further evidence is also provided by a comparison of profitability among some major multinational corporations producing automotive parts in both Canada and the U.S.A. In Table 7.2 it is possible to examine both the Before Tax and After Tax results. The Canadian operations yielded a rate of return more than 7 per cent higher than the U.S. corporation when calculated Before Tax, and a positive differential of more than 5 per cent After Tax. These results are averages based on 1973-77 results, and are slightly exaggerated by an excellent year in Canada during 1973. Nevertheless, even on a year by year basis, there was not one in which the Canadian rate of return was less than in the U.S.A.

The evidence available to the Commission suggests that:

1. The Canadian parts and accessories manufacturing industry as a whole is consistently more profitable than its counterpart in the U.S.A.; and
2. The Canadian parts producing operations of selected multinational enterprises are distinctly more profitable than the activities of these U.S. corporations as a whole.

Canada does not appear to have a competitive disadvantage in attracting potential investment to its automotive parts industry, other factors being constant.

TABLE 7.2

CANADA/U.S. COMPARISON OF MAJOR INDEPENDENT
ORIGINAL EQUIPMENT MOTOR VEHICLE PARTS MANUFACTURERS

PROFITABILITY COMPARISON

	Before Tax Profit as Percent of Net Worth		After Tax Profit as Percent of Net Worth	
	Canadian Operation	U.S. Corporation	Canadian Operation	U.S. Corporation
1973	37.9	21.8	23.1	12.2
1974	24.2	18.4	15.7	10.6
1975	20.6	17.0	12.2	10.3
1976	30.0	25.5	16.5	14.4
1977	35.4	28.2	21.0	15.5
Five Year Average	29.9	22.2	17.8	12.6

SOURCE: Financial Statements, S.E.C. 10K reports.

Re-Investment in the Canadian Parts and Accessories Manufacturing Industry

It has been noted in an earlier chapter of this Report that the Canadian Automotive Parts Manufacturers' Association has argued that investment funds should be made available to their members at below bank rate if they are to be internationally competitive in the future.

The rate of return results suggest that this industry is already internationally competitive. What has happened to the profits earned? Were they re-invested or withdrawn from the industry? For the reasons already mentioned, the Commission has no information on the re-investment practices of the vast majority of the Canadian independent parts manufacturers which are not publicly quoted corporations. The only evidence available concerns the re-investment decisions of a selected group of multinational parts producers. Table 7.3 shows that as a group these manufacturers only re-invested about one third of their substantial Canadian profits, whereas in the U.S.A. the proportion was much higher, at three-fifths of the sum of their after tax profits, depreciation and deferred taxes.

When earlier analysing problems of investment in the Canadian automotive assembly and captive parts industry, a number of "institutional barriers" to expand investment were noted. From that discussion it became clear that even though the bottom line of the profit and loss account seemed to consistently favour growth of productive capacity in Canada, there were important risk and uncertainty factors which seemed to run

TABLE 7.3

CANADA/U.S. COMPARISON OF MAJOR INDEPENDENT
ORIGINAL EQUIPMENT MOTOR VEHICLE PARTS MANUFACTURERSREINVESTMENT COMPARISONCapital Expenditure on Plants and Equipments as
Percent of After Tax Profits, Depreciation and Deferred Taxes

	<u>Canadian Operation</u>	<u>U.S. Corporation</u>
1973	44.1	67.3
1974	44.7	75.7
1975	26.0	52.4
1976	29.6	48.8
1977	31.2	56.9
Five Year Average	35.3	59.3

SOURCE: Financial Statements, S.E.C. 10K reports.

counter to the balance sheet indicators. These institutional factors would appear to have taken on an extraordinarily important aspect in deterring re-investment in the Canadian O.E.M. parts and accessories manufacturing industry. Principal among them is the reluctance to commit to new capacity in the face of changing technology and production processes in the automotive industry.

The targets of better mileage, cleaner emissions, and greater safety have lead the Big Four auto manufacturers to change the concept of the North American car. There is a general shift towards a smaller, lighter, front-wheel drive vehicle that will be globally acceptable as individual transportation. These "World Cars" may herald an age of immense scale mass production, often using automated assembly plants, robotics, and highly complex numerical control production and inventory systems. Side by side with these developments in assembly will come opportunities for parts producers to achieve world scale production of automotive components. This view of probable industrial developments in the 1980s has apparently been construed as more of a threat than a challenge by some Canadian automotive parts manufacturers.

The Big Four are contemplating a substantial increase in North American parts capability plus large-scale retooling and revitalising of existing production facilities. There will be very heavy demands upon their financial resources during this new wave of investment. It is not to be expected, given their priorities, that their investment plans will range beyond their traditional assembly activities and high-value added parts production. There will be an intensification and up-grading of

their facilities, but there will only be a limited number of major new investments in Canada which would involve a broadening of the spectrum of their parts production. Cash flow imperatives are likely to dictate that the Big Four continue to buy, rather than make, the broadest range of automotive parts and accessories. There will still be plenty of scope for Canadian parts producers to market competitively made products.

The Commission believes that the Canadian original equipment parts producing industry has the potential to develop and exploit new technologies. However, these objectives can best be realized if a number of initiatives are undertaken forthwith to make the best use of Canadian management ability, labour force skills and natural resource endowments. In general, the Commission considers that future developments in the Canadian automotive parts industry should emphasize the use of capital intensive, technologically sophisticated production methods to turn out world scale runs of key components. Likewise, the Commission believes that there must be further rationalization and corporate consolidation, together with sustained expansion of both the multinational and Canadian locally owned parts producers. To achieve these objectives, it will be necessary not only to promulgate policies which spur investment but also to devise those which give added importance to the adoption of new technology, the development of new processes and products and, in certain instances, the furtherance of basic research. The next chapter of this Report deals with the R & D question at length, and outlines some feasible policy measures. Many of these measures are complementary to the investment policy framework set out below.

This is not to argue that there will be a decline in the interesting and profitable opportunities open to the smaller Canadian parts producers. However, in some cases these producers may find that the required magnitudes of the orders are rather more than they can immediately handle. A combination of exchange rate advantages and the need for U.S. automotive assemblers to obtain supplies from independent sources will give rise to attractive sales opportunities in the medium term. These market openings will yield good returns to those smaller producers who can position themselves accordingly and retain their output flexibility in such a way as to quickly take advantage of enquiries and potential orders. They should also be able to discover new avenues for sales in export markets which will allow them to sell not only the goods they currently produce but also afford them the stimulus to develop and market new product lines.

The Commission is convinced that a prosperous and active future for the Canadian automotive industry can be achieved principally through a substantial increase in automotive parts production. While the assembly of vehicles should continue to be of importance in Canada, it is evident that better rates of return, more fruitful employment opportunities, challenging managerial environments, and opportunities for Canadian R & D are most likely to be realized through growth and expansion of the Canadian automotive parts industry. Furthermore, the future competitive realities may cause an international diffusion of automobile assembly activity. This would lead to substantial proportions of "World Cars" being assembled in the developing nations, therefore, allowing less potential for a

quantitative increase in the number of vehicles being assembled in North America. In comparison, there appears to be a much longer time horizon for the viability of North American parts production based upon advanced technology and world scale production runs. With these possibilities in mind we turn to an examination of strategies designed to assist the Canadian automotive parts industry to make a strong response to these challenging developments.

Investment Policies for the Canadian Independent Original Equipment Automotive Parts Manufacturers

The independent parts producers have been successful in selling their products throughout North America. Although Canada has run a substantial deficit in the parts trade under APTA, this is to be expected and not feared. The 1977 results show that Canada exported \$3.5 billion worth of parts to the U.S.A. and imported from there some \$6.2 billion so producing a bilateral deficit of \$2.7 billion under the Auto Pact. However, much of that import total is made up of large-scale items produced in-house by the U.S. automotive assemblers themselves. These include such costly parts as engines, transmissions and major stampings. Some production of this type has occurred in Canada, but to a large extent Canada has not had facilities to produce these items at home. In the previous chapter of this Report some conditions were described which could improve the prospects for the establishment of more in-house production capabilities in Canada. To the extent these were achieved, new output would substitute for a proportion of the present flow of capital intensive parts imports, and add to the stream of parts exports going to the U.S.A.

The independent parts producers have contributed between 50 and 60 per cent of the total value of parts produced in Canada during the 1970's. The Commission believes that the recent depreciation in the value of the Canadian dollar has enhanced the attractiveness of Canadian parts sourcing to North American automotive parts buyers. There are now real opportunities for Canadian producers to negotiate medium term contracts to supply parts to members of the Big Four. Thus, there is no prospect that the Canadian parts manufacturers are in danger of losing their existing North American market. However, the continental market may not give rise to the only opportunities for growth in the next decade. Automotive trade originating outside North America, and between third parties appears to offer substantial prospects for new markets. The Canadian parts producers will need to prepare, both in terms of technology up-grading and capacity rationalization, if the industry is to meet the marketing challenges of the forthcoming industrial decade.

Bearing in mind these factors, a policy framework for this sector of the automotive industry should have among its objectives:

1. to maintain and enhance the existing competitiveness of the Canadian parts producers so as to ensure their continuing participation in the North American market;
2. to encourage the parts producers to respond and adopt new techniques and product processes so as to keep them abreast of mainstream developments in the North American automotive industry;

3. to lay the groundwork for a rationalization of the Canadian parts industry so that as the "World Car" concept evolves, Canadian parts manufacturers may be able to produce parts in global-scale runs and reap all the attendant production efficiencies; and
4. to secure for the Canadian parts industry a greatly expanded share of the rapidly growing international vehicle parts market.

In the long run, growth in this industrial sector as a whole can only be achieved by gaining for Canada a bigger share of world trade in automotive parts and accessories and expanding capacity to serve those wider markets.

To achieve these objectives, the Commission proposes a set of policies which bear upon both sides of the global market equation.

Objectives 1 to 3 above are concerned with supply capability, not only in terms of capacity and efficiency, but also in the sense of the industry's adaptability to new production methods, re-tooling and switches in product mix. Objective 4 is concerned with the need to open up new international markets — in one country or another — for Canadian parts producers. Penetration of new markets cannot be widely achieved unless and until the parts industry is fully competitive and cost-effective internationally.

To commence the discussion of policies which might be used to assist the Canadian parts industry to expand efficiently, we shall examine policies to promote investment in new plant, equipment and machinery.

The Department of Industry, Trade and Commerce is considering a plan for the formation of an Automotive Investment Corporation (AIC). This plan has been proposed by the Automotive Parts Manufacturers' Association of Canada. In essence, it is proposed that the AIC be a government fund of \$250 million from which loans would be made to the Canadian independent parts industry at or below the U.S. prime interest rates. These loans would be available solely to this industry and earmarked for use in capital expansion, tooling, research and development.

The Commission has examined the AIC proposal in detail and finds that it cannot recommend it. There are a number of reasons why this policy is unacceptable. First, the evidence suggests that there is a high rate of return in the Canadian parts industry. Second, what evidence exists suggests that multinational parts producers may have been reluctant to re-invest their own funds in their Canadian facilities. Third, there is no evidence that the larger independent parts producers are unable to raise funds in either the Canadian or American capital markets. Fourth, there does not seem to be any reason why the Canadian automotive parts producers should be singled out for government subsidized lending arrangements.

Once interest-subsidized loans were made available to the automotive parts producers, others would quickly request them also, presenting similar arguments about the comparative costs of investing in U.S. and Canadian plants. If there is a differential cost, it is certainly not unique to any Canadian manufacturing industry. Thus, adoption of the AIC

plan would soon lead the Government of Canada into widespread subsidization of industrial loans. Not only would this be extremely costly to the public purse, but it seems likely that such subsidization measures would become a target for countervailing trade action.

The Commission acknowledges that the small independent Canadian parts makers may have some difficulties in securing adequate sources of new capital in private money markets. For this reason the Commission recommends that:

- (i) The Government of Canada recognize that there are real opportunities for profitable new investments in the Canadian automotive parts industry. In these circumstances, the Government should ensure that it is in a position to respond to the demand for loan guarantees from its adjustment assistance program, the ceiling of which has been recently raised from \$350 million to \$1 billion. In the expectation that there will be large numbers of applications from the automotive parts sector, the Commission recommends that the Government prepare accordingly. Officers who are competent and experienced in this field should be assigned to these applications so that an effective and expeditious response can be made to credit worthy borrowers.

In order to facilitate an expansion in the supply capability and an upgrading of the technological sophistication of the Canadian independent parts industry, the Commission recommends:

- (ii) A duty-free provision of materials to be used in the production of Canadian automotive parts and accessories be established. Provision be made for Canadian automotive parts manufacturers to import duty-free necessary raw materials from any source. This will enable these producers to obtain their requirements at world competitive prices. This could be particularly important for such new materials as graphite light-weight alloys, and plastics which may well be the focus of parts materials in the future.

In an earlier section, it was concluded that there were slim chances for attracting an overseas manufacturer to a Canadian site for assembly purposes. This is not because Canada offers a lower expected rate of return, but because of the political imperatives of locating inside the U.S.A. In most cases, as we have underscored in previous discussion, parts production would be more profitable, pay higher wages and be likely to have a longer technological and competitive life span than assembly

in Canada. What measures could be used to encourage overseas manufacturers to source parts from Canada, or enter into joint ventures for new production facilities here?

In discussions with the Commissioner, European and Japanese manufacturers agreed that Canada may have some comparative advantages vis-à-vis parts production over other principal automotive producing countries. Certain resources of which Canada has a relative abundance will become increasingly attractive to producers in the future, particularly as manufacturers strive to reduce vehicle weight and improve operating efficiency. If Canadians can marry their advantages in aluminum production, ferrous and non-ferrous alloys, petro-chemicals and competitively priced energy to the new technological processes in automotive parts production, then Canada's drawing power as a manufacturing location could be considerably enhanced.

To encourage overseas auto manufacturers to consider sourcing and producing parts in Canada, the Commission suggests a wider use of the designation procedure first adopted in the Auto Pact to include approved purchasers of Canadian parts for export to automotive assembly plants elsewhere. The parts purchasing agent would be nominated by a respective foreign automotive assembler as its representative for "designated vehicle importer" status. The "designated vehicle importer" would acquire the right to import foreign vehicles — produced by an undesignated manufacturer in the U.S.A. or overseas — free of duty provided that a minimum

of 60 per cent Canadian Value Added (CVA) requirement is met by its parts purchasers in the first year, moving progressively to 75 per cent in five years. This system would be an extension of the current Canadian procedure under the Auto Pact whereby North American vehicle producers can be "designated" as having fulfilled the 60 per cent CVA condition to allow them duty free entry into the Canadian automotive market.

An important consideration favouring the extended use of the "designation" approach to stimulating parts purchases and vehicle trade is its acceptability under international trading regulations. Indeed, the "designated manufacturer" formula was first adopted when certain American companies complained against Canada's 1963 "duty-remission" program, and threatened to countervail against them.¹

Recently, Canadian authorities have resurrected "duty-remission" as a technique for encouraging the sourcing of Canadian parts by Volkswagen. Similar programs have also been discussed with Japanese and other automotive producers. However, during the Commission's discussions with U.S. Treasury officials in Washington, D.C., it became very clear that implementation of a "duty-remission" program by Canada would run the risk of attracting countervailing duties by the American authorities. Even if the U.S. Administration did not take the initiative immediately in this instance, there would be a high probability that an individual

¹ For a discussion of the history of these policies and the events which finally lead to the Auto Pact and its use of the "designated manufacturer" technique, see Chapter 2.

company would make application for countervailing action. Countervailing duties could be applied to parts sold from Canada to Volkswagen in such a way as to wholly neutralize the Canadian "duty-remission" on vehicle imports into Canada. It would, therefore, discourage a major incentive for Canadian parts procurement by Volkswagen, U.S.A.

The Commission, therefore, believes that the "duty-remission" approach to inducing increased parts sourcing by foreign automotive assemblers — be they located in U.S.A. or overseas — will not be an effective policy. Indeed, this program is likely to lead to a commercial, or trade irritant situation between Canada and the U.S.A. A more acceptable policy procedure would be to extend the "designation" mechanism beyond North American automotive manufacturers to the Canadian import representatives of foreign automotive manufacturers. The terms under which foreign automobiles might be imported duty free into Canada would be identical with those used for North American vehicles under the Auto Pact. There would be no discrimination on a bilateral basis. The policy would be a clear and well understood move in the direction of freer automotive trade between Canada and the rest of the world. It would stimulate parts production activity and engender more competition in vehicle sales at home.

The policy of designating vehicle importers would work in the following manner:

- (iii) Each vehicle producer not already enjoying "designated manufacturer" status in North America under the Auto Pact will be allowed to nominate an exclusive "designated vehicle importer" in Canada.

The "designated vehicle importer" may not necessarily be owned or controlled by the foreign vehicle manufacturer. However, the "designated vehicle importer" must be the exclusive purchaser of automotive parts from Canada to the assembly plants — in the U.S.A. or overseas — of the foreign vehicle manufacturer.

The approved "designated vehicle importer" would be responsible to the Department of National Revenue for filing records of all parts exports and vehicle imports.

Upon achieving a CVA of 60 to 75 per cent, the "designated vehicle importer" would be allowed duty-free import into Canada of vehicles to a total defined value. An example using sample value is given below.

The CVA proportion would be calculated as the value of Canadian parts shipped, F.A.S. to the foreign manufacturers assembly plants as a ratio to the cost of vehicle sales in Canada. This is the same basis for calculating CVA used in the Auto Pact.

A simple example will illuminate this proposal. Supposing a "designated vehicle importer" purchases and ships \$15 million worth of parts sourced in Canada. These parts would be destined for the U.S.A. or overseas based plants of a foreign vehicle producer. The shipment could be an assortment of parts bought from various Canadian parts producers, or it could be one product supplied in bulk from one parts plant. This plant might be independently owned, a captive plant of the North American Big Four, or a new in-house parts producing facility established in Canada which by itself might achieve sufficient CVA to qualify for the duty-free privilege under the "designated vehicle importer" scheme.

The \$15 million shipment of parts would earn for the "designated vehicle importer" the right to import duty-free vehicles whose cost of sales value in Canada would be \$25 million.

In the opinion of the Commission, the policy proposal outlined above will encourage both domestic and foreign new investment in the Canadian automotive parts industry. Not only will the existing economic environment and comparative advantages of Canada be brought sharply to the notice of foreign vehicle assemblers, but an important offset will have been offered to overcome the "institutional barriers" retarding foreign automotive investment in Canada.

The opportunity to earn duty-free entry for foreign vehicles as a consequence of achieving 60 to 75 per cent CVA will be difficult to resist. This will be particularly true for those producers who have been adversely affected by recent exchange rate adjustments. The opportunity to escape

the Canadian MFN import tariff of 15 per cent on vehicles not traded under the Auto Pact should have considerable appeal in a period when such key currencies as the Deutsch Mark, Yen and even the U.S. dollar have been appreciating against the Canadian dollar. Duty-free entry would assist leading foreign car manufacturers to ameliorate, for a while, the rate of price increase of their vehicles sold in Canada. Retaining their competitiveness will give them a better chance to maintain their market shares, particularly when other indications suggest that their rapidly advancing prices have been moving their sales in a more elastic portion of the vehicle demand curve, e.g. the sudden easing of Honda sales after multiple price advances due to Yen appreciation in 1977-1978.

Once one foreign vehicle manufacturer decides to take advantage of the "designated vehicle importer" system by sourcing parts or building a parts facility in Canada, then competitive pressure in the consumer market will rapidly persuade the other producers to also adopt the plan. As a consequence, the Canadian automotive parts industry should enjoy a worthwhile expansion of investment, employment, output and foreign exchange earnings under this Plan.

Aftermarket Automotive Parts Distribution and Production in Canada

In the previous two major sections we have been discussing the outlook for future investment in both the automotive assembly and captive parts sector, and the independent parts producers. In these discussions we have not dealt directly with a very important final market for automotive

parts and accessory makers. This is the aftermarket, in which spare parts for repair and replacement are traded, and accessories are purchased for addition to original equipment specifications.

As noted previously, the trade in aftermarket automotive parts, which is not covered by the Auto Pact, accounts for a large portion of the total deficit in Canadian trade in automotive products. This deficit, which amounted to less than \$100 million in 1966, had grown to more than \$380 million in 1977. Most of these imported parts originate in the United States.

Although consideration was given during the negotiation of the Canada-United States Automotive Agreement to the inclusion of aftermarket parts, the Automotive Industries' Association of Canada requested that aftermarket parts be not included in the Agreement. The Association feared, it stated, that if tariff protection were eliminated, its members could not compete with the United States on a cost basis.

More than 375 companies in Canada manufacture aftermarket parts. Parts and components are used by individual Canadians, by garages and vehicle dealers to repair and service motor vehicles. They are distributed by a large number of warehouse distributors and wholesalers. At retail, there are a multitude of outlets, some affiliated with chain stores, others with oil companies, while many are independent specialty stores and garages or motor vehicle dealerships.

Sales in Canada of aftermarket parts are large, being in excess of one and a half billion dollars at factory prices. If accessories and ancillary automotive products are included in sales, the market exceeds \$3 billion at the wholesale level. While the available statistical data

do not permit precise comparison, it is clear that imports supply a sizeable portion of the Canadian aftermarket, perhaps close to half of the sales of parts proper, as distinct from accessories.

Imports can be divided into four categories. First, there are the major components which are produced by captive facilities of the motor vehicle assemblers in the United States. These include major stampings or assemblies made therefrom, which are not available from Canadian production. Second, there are those parts and components made by or for the motor vehicle assemblers in the United States using tooling which they own and retain in the United States. Third, there are those parts which are made in both the United States and Canada. Lastly, there are some additional items made only in the United States or elsewhere. In total, imports from all sources are substantial, amounting to \$633 million in 1976 and \$588 million in 1977.

Most of the Canadian parts manufacturers make both original equipment and aftermarket parts. In fact, out of the total 375 odd firms in the field, it appears that only about fifty are exclusively manufacturers of aftermarket parts. About 35 per cent of the total number of firms in Canada producing aftermarket parts are U.S. owned. These American firms produce in value between 60 and 65 per cent of the total output of aftermarket parts turned out in Canada.

Eighty of the Canadian aftermarket producers are component rebuilders. They rebuild used components, such as engines, and can offer them for sale at considerably lower prices than the cost of original

equipment. Because this kind of activity is not as developed in other countries and since the Canadian rebuilders have shown very considerable initiative and precision skill, they have developed a substantial advantage in selling to export markets.

Canadian producers which are owned in the United States often do not have a free hand in promoting their own export sales. In other words, they are precluded from competing with their parents when the same parts are made in both countries. Because the Canadian subsidiary firms are restricted to a more limited market, they have not the same opportunities to realize those productivity and cost advantages which volume and specialization can offer. This does not mean that there are no exports from Canada by such subsidiaries. In fact, some of them, plus a number of Canadian owned manufacturers are successfully exporting aftermarket parts from Canada. They have shown considerable initiative in searching for ways to expand their export sales. Despite these efforts, the ratio of imports to exports in 1977 was something like 3.6 to 1.

Most Canadian aftermarket exports entering the United States are subject to customs tariff duties averaging 4 per cent. Canadian tariff rates range from $12\frac{1}{2}\%$ to $17\frac{1}{2}\%$ and are considerably greater than the U.S. levies against aftermarket components. Because many truck aftermarket parts are not made in Canada, a sizeable portion of such imports enter duty-free, being of a class or kind not made in Canada.

In many ways there is a close similarity in the present aftermarket situation to conditions which prevailed for motor vehicles and original equipment parts in the early 1960s. At that time, Canadian producers experienced rising costs and increasingly keen competition from manufacturers both in the United States and overseas. Because of their ability to specialize and achieve the economies of volume output, these foreign producers could reduce their costs and prices. In face of these economic realities, even substantial tariff protection could not protect the Canadian industry and prevent imports from increasing. Since 1965, however, the reciprocal removal of customs duties between Canada and the United States has enabled Canadian producers to share the North American market for original equipment and, thus, to specialize and manufacture in much greater volume. As part of this rationalization process, many Canadian subsidiaries, which previously were precluded from exporting, were encouraged by their parent firms to specialize and rationalize their output in selected volume lines in order to supply customers in both Canada and the United States at competitive prices.

Thus, while many Canadian parts makers are now able to compete effectively with producers in the United States for original equipment business, the same firms still find it more difficult to compete for aftermarket sales in Canada, even with 12½% tariff protection or more. Despite a growing interest in the vast United States market and very low U.S. tariffs, Canadian aftermarket parts exports continue to lag far behind imports.

The prospect of a reduction in the United States tariff to minimal levels offers Canadian manufacturers a new opportunity to overcome the constraints of their present more limited markets. To make the most of these challenges, consideration should be given to an expansion of the definition of "designated vehicle importer" to include the aftermarket parts trade. Using the technique outlined in the previous section, it should be possible to devise a parallel duty-free entry system for aftermarket parts producers and distributors. Aftermarket parts could be imported duty free from the U.S.A. or overseas sources by aftermarket parts manufacturers in Canada, i.e. "designated parts importers" who met a stipulated CVA requirement. The details would have to be worked out carefully to take into account the special circumstances in the aftermarket business.

Because of the key role played by distributors in the aftermarket and their potential to assist in its rationalization, they should be considered as highly eligible for designation under such a program. The extension of the duty-free privilege to any of this class of firm would be upon the understanding that it would continue to maintain at least its historic relationship between aftermarket parts purchases in Canada and total sales of this class of commodity.²

² This caveat constitutes a ratio safeguard similar to that embodied in the original Auto Pact.

The Commission believes that there is scope for an imaginative and successful use of the "designated parts importer" procedure using both actual aftermarket parts manufacturers and parts distributors operating in Canada. There is little to be gained from further elaboration of the policy strategy proposed above, since in essence it is conceptually similar to proposal (iii) discussed in detail for the original equipment parts sector. Furthermore, many of the same firms would be affected by the initiatives for both classes of commodities and they will wish to devise complementary responses to both programs.

The Commission believes that the approach of designating importers who can qualify for duty-free entry in either or both the original equipment and aftermarket parts industry is potentially an effective strategy for expanding and rationalizing the Canadian independent parts industry as a whole. This approach is much to be preferred over any continuation or elevation of the present level of tariff protection for aftermarket parts. The Canadian industry would mark time and then continue its gradual sideslip into industrial obsolescence without some new impetus to nudge it toward modernization and specialization. Stagnation in aftermarket parts would be particularly unfortunate if at the same time the original equipment parts sector of this industry was rapidly moving towards a new found vitality of production and international competitiveness.

CHAPTER 8

REGIONAL ASPECTS OF THE AUTOMOTIVE INDUSTRY

Canadian automotive production is heavily concentrated in Ontario. In 1976, Ontario accounted for 89 per cent of the value of shipments of motor vehicles, Quebec for about 6 per cent, the Prairie provinces 2 per cent, and British Columbia and the Atlantic provinces 1.5 per cent each. In the parts sector, Ontario accounted for 98 per cent of output, with the remainder being distributed principally between Quebec and the Prairies.

By the time the Automotive Agreement was negotiated, the industry's presence in southern Ontario was well established. In 1964, Ontario enjoyed 98 per cent of both assembly and parts output. This proportion has remained constant in the parts sector since implementation of the Agreement. Ontario's share of output in assembly declined from 98 per cent to 89 per cent. GM's plant in Ste. Thérèse, Quebec, (which accounts for most of the non-Ontario increase in assembly) and the four truck plants in Western Canada account for the decline in Ontario's share of assembly operations.

It is sometimes claimed that the Automotive Agreement prevented increased regional activity in the automotive industry because the ensuing North-South rationalization of production favour southern

Ontario locations near the centre of automotive activity in the United States. It is contended that without the Agreement vehicle manufacturers would have treated the Canadian market as a separate entity, developing the industry on an East-West basis. There may be some merit in this argument that had the Automotive Agreement not been negotiated the industry might have been more regionally dispersed, but the retention of the status quo would have maintained a high cost, inefficient industry dependent on high tariff protection to survive. Furthermore, any negative effects of the Automotive Agreement on regional development would have to be weighed against the benefits in which all regions have shared, such as lower automobile prices to consumers and the indirect regional employment benefits of rapid growth in automotive activity. With respect to the latter point, the Department of Regional Economic Expansion has estimated that more than a third of the indirect employment increase associated with expansion of automobile production takes place outside of Ontario.

Outlook for Regional Automotive Investment

Assembly

Prospects for investment by U.S. companies in new auto assembly plants are not favourable at this time because of continuing excess capacity in North America. There may, however, be some limited opportunities for commercial vehicle assembly as this market continues to

expand. In a regional context, there may be some prospects for further investment in truck assembly in Western Canada as a result of rapid resource-based growth in that region.

Investment in assembly operations by off-shore manufacturers also does not appear to be favourable at present. Although west coast and east coast locations might be attractive to Japanese and European manufacturers respectively, as compared to central Canadian locations, initial investments will almost certainly be made in the United States, as indicated in Chapter 5.

Some European vehicle manufacturers informed the Commission of proposals from provincial authorities to establish assembly operations in Canada. Such proposals invariably involved small-scale, inefficient assembly for the Canadian market. Although these small-scale assembly operations may confer short term benefits on regional economies, few have proven economically viable over the longer term — witness the closing down of the Bricklin operation in New Brunswick, Renault's in Quebec and of Toyota's in Cape Breton. Their subsequent closure can result in painful adjustment for affected communities. The Commission recommends, therefore, that federal and provincial governments not pursue assembly investment by offshore producers, unless such investment is of sufficient scale to ensure long-term competitiveness. This implies that in most cases the plants would need to serve both Canadian and U.S. markets.

Parts

Notwithstanding the concentration of parts production in Ontario, prospects for regional investment in parts facilities appear to be more favourable than in assembly. As the automotive industry increasingly substitutes light-weight materials for iron and steel there should be new opportunities for regions which have a strong competitive position in the manufacture of these alternatives. GM is considering whether it requires an aluminum engine block facility with Quebec being a possible site, primarily because of the local supply of aluminum ingots and relatively inexpensive energy. Japanese manufacturers have expressed interest in aluminum parts facilities on the west coast because their own aluminum industry faces high energy costs. Interest has also been expressed in the manufacture of asbestos brake linings in Quebec. Another opportunity area which merits exploration is plastic parts production. One third of Canadian plastics production currently takes place outside Ontario, principally in Quebec and the West.

It should be noted, as well, that investment by offshore vehicle manufacturers in large-scale captive parts facilities to take advantage of duty-free entry arising from the proposed revisions to "designated manufacturer" criteria would not necessarily be most advantageously located in southern Ontario. In addition to raw materials and energy considerations, proximity to the assembly plants requiring these components in the U.S., Japan or Europe will be an important factor in the investment decisions.

Investment Incentives

The attractiveness of particular regions for the kinds of investments outlined above will, of course, be augmented by the regional development incentives available from the federal and provincial governments. These incentives are intended to offset the locational advantages of the industrial heartland.

It can be argued that the principal issue is not where in Canada automotive investment will take place, but whether it will take place at all in Canada in competition with the United States, Mexico, Brazil or elsewhere. The Commission believes that the overall Canadian investment climate has improved to the point where Canada can obtain a reasonable proportion of automotive investment on its merits. Subject to the caveat above, some of this investment could be expected to be located in the regions enjoying certain comparative advantages, reinforced by regional development assistance. In the Commission's view a rigid approach is neither warranted nor desirable.

Unfortunately, governments on both sides of the border have intervened strongly in the investment decision-making process in recent months by offering incentives to locate in prime industrial areas. This practice has seriously undermined Canada's regional development objectives by, in effect, neutralizing the impact of legitimate regional incentives. The Commission is opposed to such ad hoc incentive payments as only the shareholders win when the automotive producers hold a

subsidy auction and award the new plant to the highest bidder. Competitive subsidization by municipal, state, provincial, and federal governments will lead to irrational decision-making.

In the circumstances, the Commission would urge that the Canadian government join with the United States and other governments to try to resolve the problem of competitive subsidization on a multilateral basis. While the resolution of this problem will not be easy, it is to be hoped that the current GATT negotiations aimed at developing a code governing such subsidies will be successful. In the event they are not, the Canadian and U.S. governments should seek to work out a bilateral arrangement. It must be recognized, of course, that one of the main problems is that of ensuring compliance by other levels of governments in each country.

CHAPTER 9

RESEARCH AND DEVELOPMENT

Design, research and development activities employ highly qualified scientists, engineers and managers. They create an atmosphere conducive to the wider development of technology-based industries. Although the North American automotive industry undertakes a great deal of R & D, very little of this occurs in Canada.

The U.S. automotive industry spent an estimated \$3.4 billion on R & D in 1977 — an increase of about 15 per cent over the previous year. R & D expenditures in Canada amounted to only about \$8 million, and most of this was incurred by the parts makers. The Canadian subsidiaries of the "Big Four" undertook about \$2 million in R & D, but paid in excess of \$300 million for R & D performed on their behalf at U.S. installations. The technology developed in the United States is then embodied in new parts, designs and styles used in Canadian assembled vehicles.

TABLE 9.1

RESEARCH AND DEVELOPMENT EXPENDITURES

AUTOMOTIVE INDUSTRY IN CANADA

\$ 000

	<u>1964</u>	<u>1973</u>	<u>1975</u>	<u>1976^P</u>	<u>1977^P</u>
(1) *	--	3,251	2,491	2,672	2,101
(2) **	--	4,347	4,385	5,025	5,420
(3) ***	--	400	1,150	1,234	1,092
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TOTAL	1,894	7,998	8,026	8,931	8,613

NOTES

1964 covers R & D expenditures in all transportation equipment manufacture except aircraft and parts.

* (1) Covers Motor Vehicle Manufacturers

** (2) Covers Motor Vehicle Parts and Accessory Manufacturers

*** (3) Covers Truck Body and Trailers

P Provisional

SOURCE: Statistics Canada

These figures suggest strongly that there is a serious and growing imbalance in the technological composition of Canada's automotive industry. The imbalance is particularly severe in the automotive assembly industry, where if anything, there has been a reduction in real R & D activity since North American assembly was rationalized.

It has been stressed in earlier sections that even when Canada is fully competitive on all counts, there still exist some fundamental "institutional barriers" to attracting automotive activity to Canada. The presence of these "institutional barriers" was recognized by both American and Canadian negotiators when the Auto Pact was originally negotiated in 1964, but none of the barriers to R & D in Canada have been materially reduced.

The principal institutional barriers to greater diffusion of North American R & D activity stem from the organizational structure of the industry. The industry has always undertaken the bulk of its R & D in the United States. It could be argued that by integrating the U.S. and Canadian markets the Agreement took away the rationale for any independent Canadian R & D capability. The North American automotive industry has rationalized itself on the basis of centralized head office and R & D functions and decentralized production. Certain other international industries have been organized in such a way that particular branches of the firm undertake all functions, from R & D through to production and marketing. Neither system can be considered superior to the other from a

technical point of view, and it would be naive to assume that the automotive industry will find it advantageous to change its way of doing business without a substantial incentive to do so.

In the North American automotive industry, R & D activities are clustered close to head office locations because of the importance of communications between key personnel. The directors and senior staff of R & D facilities must have well-forged links with top management, marketing executives, production engineers, and other technical people in the design sector of the automotive industry. The Big Four consider there are significant economies of scale to be achieved through consolidation of their design and R & D activities in proximity to head offices or centers of technical expertise.

This interaction between key personnel groups in common locations creates a substantial barrier to decentralization of R & D operations. It should be pointed out that more than 90 per cent of R & D expenditures are devoted to the development of new and improved products and production processes. Only one-tenth is spent on more basic research, which may not have immediate application.

In recent years, the upsurge in automotive R & D has been prompted by the need to meet new U.S. standards for energy conservation, emission control and safety. For instance, in 1975, General Motors spent \$485 million out of a total budget of \$1.1 billion on emission control research. This is likely to be a primary R & D concern to 1985 and beyond. The Big Four will have great difficulty in meeting these standards, particularly the fuel economy

requirements. It is difficult to conceive of the automobile manufacturers conducting R & D in Canada which has been necessitated by American regulations. Differences in Canadian environmental and safety standards could create the need for independent developmental work in Canada.

A number of Canadian observers have suggested that Canada is the obvious site for research into problems related to northern climates. The automobile manufacturers respond, however, that their products are suited for all North American climatic conditions and that, therefore, a car built for Canadian conditions already exists, to which the consumer may add whatever heavy duty or special cold weather packages he may require — which is open to question.

Notwithstanding existing institutional barriers, there is evidence to suggest that some R & D could be conducted in Canada at less cost than in the United States. The experience of Canadian companies in the telecommunications field suggests that costs in Canada do not compare unfavourably with those in, say, California. Canadian R & D has a highly successful record in a number of industries, both from a technical and commercial standpoint.

Canadian tax treatment of R & D operations appears to be as generous or more so than in the United States. However, substantial U.S. government grants to industry in that country have contributed greatly to the overall financing of R & D efforts. The cost of equipment, much of which is imported into Canada, is generally more expensive than in the United States if only because of customs duty and sales taxes levied on the duty paid value.

To summarize, Canada is a competitive site for R & D installations. Canada may, however, be at some disadvantage vis-à-vis the United States because of U.S. government grant programs and due to the higher cost of imported apparatus. To overcome the "institutional barriers" to expanding the Canadian share of North American automotive R & D requires a broad range of policies.

Measures to Increase R & D in the Canadian Automotive Industry

Currently a number of measures are in effect to provide incentives to all industry to establish or expand R & D activities in Canada. These include: (1) regular tax deduction of 100 per cent of R & D expenses from taxable income; (2) special tax credit of 5 per cent of R & D expenses, introduced in April, 1977 to run for three years; in designated areas this amount increases to $7\frac{1}{2}$ per cent and 10 per cent; and (3) special additional write-off of 50 per cent of the amount by which the current year's expenditures are in excess of the average of the preceding years.

Some examples of the way these measures may be used to advantage by Canadian firms are given in Appendix D of this report. Despite these and other incentives, the motor vehicle and parts industry in Canada has undertaken little R & D. It is, therefore, necessary to provide additional incentives.

1. Special CVA Credit for Increased Research and Developmental Activity in Canada

Vehicle producers should be permitted for a period of five years to claim 200 per cent CVA credits for annual

increments of R & D expenditures over a base period value. Under this proposal, R & D expenditures dispensed in-house or in independent laboratories or universities could, upon acceptable verification, be an allowable credit.

2. Improved Tariff Rates on Imported Research Equipment

The government should consider implementing duty drawbacks on imported equipment earmarked for research and development purposes in Canada. The drawback for authorized imports of this type might be in the vicinity of two-thirds of the duty payable.

3. An Additional Element in the Program for Export Market Development (PEMD)

It is suggested that the Department of Industry, Trade and Commerce institute a new section of the existing PEMD program. This section would be designed to make grants to manufacturers who wish to shop for ideas or designs from outside Canada which could be developed here. It would also provide special assistance to Canadian producers with an innovative process or product to lease or sell outside the country.

4. A Decrease in the Tax Allowance for the Cost of Imported Research and Development

As noted previously, the Big Four automotive assemblers are charging their Canadian subsidiaries more than a quarter of a billion dollars annually for R & D done on their behalf

in the United States. Should the measures proposed by the Commission not prove effective in increasing automotive R & D in Canada, the government should give serious consideration to adjusting the basis upon which R & D payments to foreign affiliates are deductible for tax purposes. One approach would be to balance these deductions against R & D expenditures made in Canada. For example, transfer payments might initially be deductible in a ratio of \$5 to \$1 of Canadian R & D. The ratio could then be adjusted progressively until it became \$1 deductible for transfer payments for every \$1 spent for Canadian R & D.

Several of the foregoing proposals to increase R & D activity in the automotive industry might be applicable to a broad range of industries in the Canadian manufacturing sector. The problem is clearly not limited to the automotive industry, and similar types of measures might assist in offsetting some of the institutional barriers which have developed over the years.

Additional Measures to Increase R & D in the Canadian Parts Industry

The Commission believes that the Canadian parts industry has the potential to develop and exploit new technologies related to certain areas in which Canada may have a competitive advantage vis-à-vis the principal automotive producing countries. In fact, European and Japanese manufacturers stressed this point in discussions with the Commission and expressed some interest in possible joint ventures in

component development and manufacturing. Certain resources of which Canada has relative abundance will become increasingly important in the future as manufacturers strive to reduce vehicle weight and improve operating efficiencies. These include aluminum, ferrous and non-ferrous alloys, plastics and composite materials and, as well, a secure supply of competitively priced energy and petrochemical feedstocks. A key to future development will be the ability to marry these material technologies with automotive technologies.

Existing R & D programs go some way in encouraging indigenous innovation in the auto parts sector. Innovation assistance under the Enterprise Development Program (EDP) of the Department of Industry, Trade and Commerce, which provides grants of up to 50 per cent of approved development costs, has been used relatively frequently by the smaller, Canadian-owned parts producers. But larger parts makers would not in most cases be eligible for assistance because the EDP requires that the proposed project constitute a "significant burden" on the firm's resources.

To give a new impetus to research, development and design activities in the Canadian automotive parts industry, it is proposed that the fund available under the EDP be substantially enlarged. Furthermore, it is proposed that the financial assistance available for individual firms also be enriched, particularly with respect to the smaller Canadian-owned operations.

With respect to the smaller parts makers, who have more limited financial and technical resources at their disposal, it is proposed that product development assistance take the form of grants to cover no less than 75 per cent of costs and for particularly promising ventures, where

financing would be a burden, this assistance may be raised to cover full costs. Also, the Commission recommends that the test of "significant financial burden" that currently applies over the whole range of assistance and for all applicants be eliminated for the small independents.

For the foreign-owned parts makers, which for the most part are the large enterprises, the Commission recommends that the assistance take the form of forgivable loans, not to exceed 75 per cent of the cost of the development project. In all those instances where the project is a commercial success, the firm would be expected to repay the loan in full with reasonable interest over a period of years.

On the basis of consultations with the industry, the Commission is concerned that the EDP embracing such a variety of industrial assistance and such a range of industries runs the risk of becoming unwieldy and excessively bureaucratic. Recommendation two proposed that an advisory body be established to conduct an annual review of developments pertaining to the automotive industry. The Commission recommends that this body also be charged with the task of reviewing the operations of the EDP as it relates to the automotive industry.

CHAPTER 10

THE "CANADIAN CAR"

Canada is the only major automotive market in the world which does not have an indigenous auto manufacturing capability. As noted previously, France, Italy, Germany, Britain and Japan all have several indigenous manufacturers. Even Sweden whose domestic market is one-third the size of Canada's can claim two vehicle manufacturers. The reasons for the development of the Canadian industry along a path quite different from other countries lie in history, but the Commission has asked itself, like other observers of the Canadian automotive scene over the years, whether there are any prospects in the future for the establishment of a viable, Canadian-controlled auto manufacturing capability.

The attractiveness of the Canadian car concept lies in its potential to redress the major structural deficiency which the Commission identified in other chapters as being endemic to the Canadian industry, namely its truncated, branch-plant organization whereby research, design, development, engineering, product planning and other corporate activities are virtually all conducted by the parent organization from a U.S. base and only production and distribution are decentralized.

There does not appear to be any interest on the part of the vehicle manufacturers in considering changing the present system. Therefore, the Commission decided to examine in some detail the prospects

for establishing an independent Canadian capability. The establishment of such a capability would help foster a more balanced, integrated industry in which the entire innovation cycle from research through to marketing would be conducted from a Canadian base. This would permit the development of a car better suited to harsh Canadian driving conditions than those currently offered; it would generate increased employment for Canadian engineers, scientists, technicians and business graduates; and it might result in increased production employment if the Canadian car displaced imports and penetrated export markets. Perhaps more importantly, in the longer term, the Canadian car would help secure Canada a place in the future of the automotive industry which might not otherwise be available under foreign ownership and control. As the automotive market in western industrialized countries approaches saturation and market growth shifts to developing countries, production may also turn increasingly to developing countries, leaving developed countries the knowledge-intensive research, design, engineering, production of high technology components, and corporate planning activities. To some extent, this trend has already begun as Canadian production locations compete with Mexico and Brazil. If the automotive industry does indeed evolve in the same manner as textiles and consumer electronics — i.e. production in low-cost developing countries and product development, management and control in developed countries — only those countries with an indigenous capability may be in a position to maintain a presence in the industry of the future.

If a Canadian car were to be developed, it would need to be produced in substantial volume in order to be cost competitive with

vehicles currently offered available to the consumer. The Commission estimates that although scale economies in some aspects of automotive production are not completely exhausted beyond 500,000 units annually, a volume of 250,000 units a year would involve only a marginal cost penalty and would permit an enterprise to be competitive provided that model changes were infrequent. A facility producing 250,000 vehicles annually would create about 15,000 automotive jobs, although some of these could be at the expense of existing employment.

The Canadian car would need to find a "niche" in the market where there is sufficient demand and where it can compete successfully with vehicles of a similar type. The Canadian car envisaged by the Commission is a "northern car" designed to operate in a superior fashion in Canadian climatic conditions. This would include such attributes as front wheel drive for traction, superior starting capability, more efficient heating and defrosting systems and improved corrosion resistance. The total market for passenger cars in regions subject to "northern climatic conditions" might approach 4 million vehicles annually: 1 million in Canada; another 2 1/4 million in the northern part of the United States, and another 3/4 million in the Scandinavian countries and Europe. To achieve a volume of 250,000 units, the Canadian car would need a market penetration of about 6 per cent, or 10 per cent in Canada and 5 per cent in export markets.

The Commission estimates that the cost of setting up new integrated facilities to produce 250,000 units annually could approach \$2 billion, including launch costs. The costs are broken down as follows:

Vehicle assembly	11%
Engine line and foundry	27%
Transmission line	11%
Stamping plant	19%
Trim plant	7%
Components manufacture and assembly (non-proprietary components excluded)	25%
Total	100%

This \$2 billion figure does not include R & D costs which, at a minimum, could amount to 5 to 10 per cent of the cost of the facility or \$100 to \$200 million. This estimate is based on the assumption that a great deal of existing technology is acquired from other sources. The \$2 billion estimate does not include the costs of setting up a dealer and service network which involves major investments for each dealer. It should be pointed out, however, that initial costs could be reduced substantially by procuring major components, such as engines and transmissions from outside sources. In fact, it is only reasonable to expect that most of the major components would be purchased from other suppliers, at least at the outset because the economies of scale would not permit economic production on this scale. Thus, the initial operation might largely be confined to assembly, which would require a plant cost of approximately \$225 million.

The staggering costs of establishing a new, world scale, integrated automotive manufacturing facility are matched by the risks inherent in such an undertaking. First, there is a certain degree of technical risk associated with launching a new product; even established auto makers bring out new models with design and

engineering faults which result in costly recalls and loss of consumer acceptance. Second, there is the risk that costs of production will be greater than forecast, that prices will be too high to attract customers, or that they will be forced down to unprofitable levels by competition from existing manufacturers. Third, and perhaps most importantly, there is the risk of consumers not being attracted by the design and overall concept of the vehicle in sufficient numbers to make its manufacture profitable. The risk is exacerbated if only one or two models are offered. The major vehicle manufacturers spread this risk by offering a wide range of models whose production can be accelerated or reduced according to the dictates of the market. Moreover, consumer loyalty to a particular name takes time to develop; some 60 to 80 per cent of each vehicle producer's sales are from repeat business. Consumer acceptance of a new car whose existence in the market may be short-lived would be difficult to establish.

The development of a viable Canadian vehicle manufacturing company would become increasingly difficult over time as concentration in the industry increases. Some observers estimate that only some ten manufacturers world-wide will survive. As examples of this trend, Peugeot-Citroën recently bought out Chrysler's European operations, making it the largest producer in Europe; Renault and AMC, and Renault and Mack are negotiating joint marketing and production arrangements; joint engine development programs are becoming quite common among European manufacturers; and the Japanese government is interested in encouraging mergers in its industry in order to maintain international competitiveness.

These arrangements have been necessitated in part by the development of the international or "world car". A world car is an automobile sold in international markets and whose component specifications are virtually identical, wherever produced. This enables the manufacturer to achieve economies of scale heretofore unrealizable because of different market requirements. Smaller vehicle manufacturers will have difficulty in competing in the mass market unless they make arrangements that will give them similar economies.

A number of companies appear to have decided that their future viability as relatively small and independent manufacturers depends on establishing a place in the market where their automobiles sell on the basis of quality, performance, and reliability and command a price premium. Some manufacturers have been very successful at exploiting this segment of the market, while others have had difficulties and their long-term survival may be in doubt. The prospects for the success or failure of a Canadian car are difficult to judge on the basis of others' experiences, but two obvious prerequisites are superior quality to avoid competing head-on with the mass-produced world car and aggressive export marketing to overcome domestic demand deficiencies.

On the basis of these considerations, the Commission considers the likelihood of a Canadian entrepreneur establishing a motor vehicle company on an internationally competitive scale to be

extremely remote. There are, however, a number of options available to government to make the environment more hospitable for the establishment of a Canadian car company.

One option would be to protect the Canadian market from import competition and perhaps restrict the activities of foreign producers in Canada in order to guarantee a Canadian car the required number of sales. The Canadian market is large enough — one million passenger vehicles a year — to make this option feasible. The Commission does not believe, however, that this is the direction which government policy should take. It would restrict unduly personal freedom and consumer choice. It would inevitably increase prices to the consumer. It could well result in a trade war with our major trading partners which would be extremely damaging to Canada's overall economic interests. It would jeopardize the achievements made in output and employment in this industry over the last dozen years, and it would inevitably involve government ownership and its attendant problem.

A second option would be a Canadian takeover of an existing vehicle manufacturer. There are several manufacturers who may experience difficulty in adjusting to the automotive requirements of the 1980s and who may be interested in selling off their Canadian operations. The Commission has found no evidence of a desire on the part of any company to divest itself of its Canadian interests and does not consider this to be a feasible option at this time.

Another means of establishing an indigenous presence in the industry would be to undertake a joint venture with an existing producer. Such a joint venture would have a number of important advantages. Access to the design and engineering capability of an established producer would substantially reduce technical risk, especially if the Canadian car were initially based on an existing model. Minority equity participation by the foreign producer would spread financial risk. Access to an existing dealer network would significantly reduce costs and would enhance consumer identification with a new product.

The Commission explored this alternative in some detail in its discussions with American, Japanese and European motor vehicle manufacturers. None of the foreign manufacturers expressed any great interest in the joint development of a Canadian car. Their view was that by and large existing vehicles satisfied the Canadian consumer's needs and that a special northern car would be too expensive to achieve a sales volume needed to support an internationally competitive facility. Many manufacturers felt that their own vehicles were evolving into the kind of car that would be better suited to northern conditions with the increasing use of front-wheel drive, better corrosion protection and improved electrical systems. Some cited the lack of consumer acceptance of special optional "winter packages" which increased the price of the automobile. The manufacturers also expressed the view that a Canadian car would not be able to compete, at least initially, against GM and Ford without some measures of protection. Some suggested that the

development of a niche in the small specialty market (50,000 vehicles annually) might support a high quality, expensive automobile but that competing in the mass market was too difficult.

The Commission observed as well from these discussions that a joint venture of this kind did not appear to dovetail with any major producer's corporate strategy. The industry is, for better or worse, going in the opposite direction towards the development of a world car which will be suitable for all markets, and the concept of a special northern car is anathetical to this approach. Moreover, the producers who are well-established in the Canadian market might view the Canadian car as a possible threat to some of their existing sales and not just incremental business. On the other hand, the producers who have an insignificant share of the Canadian market at this time and who, therefore, might be expected to have an interest in a joint venture, tend to view Canada as part of the North American market, not as a separate entity, and in these circumstances the requirements of the much larger U.S. market take priority in the allocation of scarce resources.

The Commission cannot recommend on the basis of its discussions with virtually all of the world's major automobile manufacturers that the government actively pursue the Canadian car option at this time. This is not to say, however, that the Canadian car should be completely dismissed from future consideration. As long as developments in the automotive industry are favourable to Canada, the cost and risk of this

option will remain high relative to the potential benefits. But failure to ameliorate trading arrangements or failure of key participants to treat the Canadian market in a fair and equitable way may make the Canadian car a much more attractive option than it is today.

CHAPTER 11

SOME CONCLUDING OBSERVATIONS AND RECOMMENDATIONS

Unlike most of the advanced industrial countries, Canada does not have, nor has it ever had, an indigenous integrated automotive industry. Almost all the actual or perceived problems for Canada in this sector flow from this compelling fact, e.g. a large and persistent sectoral balance of payments deficit, the absence from Canada of any significant decision-making or other head office functions, the lack of significant design, research or development activities, a weak machinery and equipment support industry, constant danger of inadequate investment, an inadequate share of employment both qualitatively and quantitatively, products not quite suited to the country, climate and geography.

The large and continuing international accounts deficit in this sector is made up of many elements of which the most persistent are; the deficit for finished vehicles in trade with overseas countries; the deficit for aftermarket and service components with the U.S. and overseas countries; payments for research and development and for business services; the remittance of profits, dividends and interest to U.S. owners and investors; the deficit in machinery and equipment used in the auto industry; and a deficit on original equipment parts trade with the U.S.A.

Contrary to widely held public perception, owing in part to incomplete data or misinterpretation of published statistics, Canada does not have a chronic trade deficit with the U.S.A. under the Automotive Products Trade Agreement (Auto Pact).

In seeking answers to the issues confronting Canada in the automotive sector, it is tempting to speculate on the possibility of an all-embracing solution in the form of the creation of a domestic integrated industry. The existence in this country of an annual market for some 1 million automobiles and 350 thousand commercial vehicles gives support to this idea in that it provides a basis at least for its technical feasibility. The Commission believes that such a development will not be forthcoming in response to the initiative of either Canadian or foreign entrepreneurs. If it were to be attempted, it would have to come largely as a government enterprise. Given the facts that, from the world point of view, we are dealing with a mature, highly competitive industry approaching market saturation in the industrialized countries, the huge capital costs entailed in designing, producing and marketing of a Canadian range of cars, the formidable risks of failure in a relatively open market, the massive disruption to established businesses and channels of trade in Canada and abroad, the Commission has concluded that it would be imprudent for government to consider such a course unless circumstances change to the point where Canada's future in the industry could not otherwise be assured.

The Bladen Commission of 1960, the initiators of the duty-remission programs of the early sixties and authors of the Auto Pact of 1965, presumably considered the alternative of creating an indigenous integrated auto industry in Canada and rejected it in favour of more modest and less comprehensive solutions. Developments since then both in Canada and abroad and the massive expansion of assembly and parts production in Canada associated with the Auto Pact make the option of a Canadian car even less practical now than it may have been at that time.

The Canada-U.S. Auto Pact did not solve all the actual or perceived problems confronting Canada in the auto industry. Indeed, it did not set out to solve all these problems. It was a limited purpose agreement invented to head off a threatened trade war between Canada and the United States kindled by Canadian efforts to halt the decline of the Canadian auto industry. Its essential purpose was to obtain for Canada a better share of North American assembly and parts production and employment than it had in 1964, without imposing additional penalties on the Canadian consumer or Canadian labour. It sought to achieve this objective by introducing conditional free trade with the U.S. in this sector, combined with a guarantee of certain minimum assembly and parts production in Canada relative to Canadian vehicle consumption. It more than achieved its limited objectives. It failed to do many other things which some Canadians, perhaps mistakenly, expected of it. What did it achieve? Where did it fail?

Looked at from the Canadian side, the Auto Pact rescued Canada from the inefficient high-cost assembly and parts production associated with short runs, small scale, and highly differentiated car models and

parts to serve a relatively small and highly protected domestic market. By encouraging the production of a more limited range of cars and original equipment parts for the whole North American market it soon developed the capability of competing fully with assembly and parts plants on the U.S. side of the border. Output in Canada grew by leaps and bounds in both absolute and relative terms. On average, during the 14 years since the Pact, the value of output in Canada of North American vehicles and parts was approximately in balance with the value of consumption in Canada when valued at the factor gate, net of taxes and other charges not directly involved in the production process. A large number of new jobs were created. Wages advanced to virtually close the gap with those in the U.S. Price differentials declined substantially to the benefit of consumers.

The results of the Pact were disappointing in several important respects. The Canadian industry performs virtually no design, research and development work. Indeed, certain tasks of this nature which in the pre-Pact era were carried out to make minor changes in U.S.-designed cars or to apply different paint techniques were lost to Canada. Similarly, certain head office activities performed in Canada in the pre-1965 era such as procurement were also largely lost to Canada. In short, under the Pact, the Canadian industry lost none of its satellite characteristics. If anything, this condition became more pronounced as the U.S. side took advantage of the free trade arrangements to rationalize its overall activities, including those in the management, professional and scientific areas of its operations. But it would be a mistake to conclude that much

was lost to Canada in this process. The simple truth is that Canada had virtually nothing real in this area before 1965. We have even less now: but the appearances and the realities are now closely in line.

A perceived failure of the Auto Pact relates to the regional distribution of the Canadian automotive industry. From its inception Canadian automobile and parts production were concentrated in Southern Ontario in close proximity to the U.S. industry and the largest segment of the Canadian market. A major assembly plant in St. Thérèse, Quebec, some truck manufacturing in the West, a failed Renault plant in Québec, a failed Toyota plant in Cape Breton, and a small scale Volvo plant in Halifax, are hardly a large tribute to the regional dispersion impact. However, the supply of materials to the automotive industry has, no doubt, improved the regional benefits balance sheet, but not in a decisive way. It needs to be said that there are no specific provisions in the Pact to induce regional dispersion although it was not unreasonable to have expected that out of a large total expansion the ripple effect would take the benefits further and deeper than in fact occurred.

Another perceived failure which has attracted a great deal of attention in recent years relates to the balance within the industry itself as between assembly and parts production. This perception is based on an examination of the trade statistics which show a substantial deficit for Canada for auto parts and a surplus for vehicles. While these facts are obvious, an analysis of production and employment in the industry reveals greater growth in both absolute and relative terms in the parts sector as compared with assembly.

A failing in the view of some Canadians is the fact that the Pact does not appear to have provided any significant inducement to the greater ownership and control of automotive companies by Canadians. There has been no change whatever in the ownership and control of the automobile manufacturing companies operating in Canada, and the largest of the independent parts makers are wholly owned Canadian subsidiaries of U.S. corporations. Independent parts companies in Canadian hands have been reduced in numbers, although the survivors are much improved in strength and quality. It is disappointing that no more than a few new entrants in the industry are owned and controlled in Canada. The Pact itself had nothing to say about ownership and control of the companies participating in the industry, but again it was not unreasonable to have hoped that vastly expanded opportunities would be no less attractive to Canadian entrepreneurs than to American entrepreneurs.

From a somewhat different vantage point, but no less important, the Auto Pact has not lived up to its early expectations of contributing a strong and steady positive influence on Canada-U.S. relations in this sector or on our economic relationships more generally. Although the Pact has demonstrably been of substantial benefit to both Canada and the United States as well as to individual residents and corporations of both countries, it is nonetheless true that its decade and a half of history has been attended by recurrent shrillness and complaint on both sides of the border, sometimes even threatening to end in the sudden demise of the Agreement.

The Pact itself is vague on the subject of trade balance, and even more vague on the subject of the life of the safeguards. This is perhaps why it has been the subject of continuing controversy. The U.S. insists that the safeguards are transitional and must go in favour of pristine free trade. Canadians cling stubbornly to the safeguards insisting that they were meant to be permanent — sometimes even after some of them may have outlived their usefulness. Some Canadians also contend that the Pact's success or failure should be judged by whether or not, year in and year out, Canada achieves production in Canada equal to consumption not only in total, but also in the components of the trade. It is sometimes said of international agreements that their quality is attested to by their survival in circumstances where they satisfy no one, at least not completely. If this be true, the Auto Pact is perhaps a good living testimonial to this dictum.

There is perhaps one truth which has been distilled from the ongoing controversy surrounding the Auto Pact. It would appear from the record that as a practical matter, the greatest satisfaction — or at least the least dissatisfaction — on both sides of the border, can be observed when the commodity trade governed by the Pact is roughly in balance. If peace be our objective, we may have discovered a useful guidepost even though it may have nothing to recommend it in good theory or in logic.

It is somewhat of an enigma that the Auto Pact has not been modified in any significant way since its inception. Apart from the addition of snowmobiles and certain off-highway vehicles where inadvertence rather than policy dictated change, the Pact stands as originally

negotiated. While this may be interpreted as a tribute to its quality and original wisdom, it is a disappointment in at least several respects to its progenitors.

First, it is undeniable from the record that there have been important changes in the industry which demand, let alone justify, modification in the Agreement. Yet, like an ancient religion, even the most minute clause attracts its worshippers. This may be more the fault of the parties to the Agreement than the Agreement itself. Nonetheless, it needs to be said that the Auto Pact has failed to provide a flexible framework within which real and sometimes urgent problems cry for attention. This deficiency needs to be corrected.

Second, it is also an undeniable fact that, despite the hopes and aspirations of the originators, the Auto Pact has failed to provide the stimulus or inspiration to beget similar agreements in its image for the enhancement of international specialization and efficiency in the massive trade between Canada and the U.S.A. Although it is true that there are no obvious examples of other cross-border industries where quite the same conditions prevail, it is no less true that there are many examples of industries in Canada, and to a lesser extent in the U.S., where a greater measure of specialization in the respective jurisdictions would yield substantial benefits for the citizens of both countries. Conditional free trade arrangements in such industries, where Canada might venture forth, without the danger of being blotted out, deserve continuing attention in both countries. It is again something of an enigma at a time when more and more Canadian voices are being heard in support of such initiatives that the response from the U.S. side has been a deafening silence.

The Commission has explored with senior U.S. officials the desirability of reformulating the Auto Pact at this time, given the changing conditions and needs which have emerged in the two countries since the Agreement was signed, as well as the formidable restructuring which is likely to take place in the world industry during the next decade. It has not been encouraged to believe that this would be a propitious time to engage in such a re-examination. Preoccupation with more compelling issues, concentration on the multilateral tariff negotiations in Geneva as a larger and more immediate concern, reasonable satisfaction with the present state of Canada-U.S. trade including the automotive sector, and stresses and strains in the executive and legislative decision-making process militate against opening new issues from the U.S. point of view. The Commission has also gathered the impression that these same considerations together with concern about relationships with other large trading partners have obscured for the moment the long-term interest which the United States may have in exploring possibilities for imaginative trade initiatives in the Canada-U.S. bilateral context. For these reasons the Commission has concluded that it would not be timely to request the U.S. to reopen the Auto Pact. It has also concluded that it would not be fruitful at this time to initiate discussions looking to the extension of automotive type conditional free trade in relation to other industrial sectors. Following the completion — or termination — of the Geneva multilateral negotiations, it may be useful to canvass these possibilities afresh.

The Canadian automotive industry today assembles substantially more vehicles than the entire Canadian vehicle consumption. The assembly industry is specialized, efficient and competitive. Although large new investments in assembly facilities will be needed to meet the changing requirements of the next decade over and above the traditional model changeovers, this is not likely to result in new assembly plants in North America. Canada cannot, therefore, look forward to major additional assembly capacity. Present plants, when modernized, will be fully capable of turning out larger numbers of smaller vehicles in line with the moderate growth anticipated for vehicle consumption in North America.

Overseas automobile producers have been canvassed with a view to ascertaining their intentions with respect to the manufacture of motor vehicles in North America. There is no reason to expect, during the near future, any major moves in this field along the lines of the Volkswagen plant in Pennsylvania on the part of the Japanese or the European automotive corporations. In any event, Canada would not rank very high in their priorities should any such assembly operations materialize in North America.

To the above considerations should be added the further observation that assembly operations with their requirement for relatively unskilled, relatively low cost labour, are progressively gravitating to Third World countries of Latin America, the Far East and the Middle East, all of which are competing with one another for assembly plants. This may well be an inevitable trend, and it is probably not in the Canadian interest to resist these developments with extraordinary measures of subsidization or increased protection.

The future holds more promise for Canada in the potential for new and enlarged facilities for the production of original equipment parts to be used for assembly in Canada, the United States and elsewhere in the world. Prospective developments in the design of smaller, lighter, safer, and more efficient cars to meet government mandated requirements as well as the imperative of rising energy costs will require refurbished and new plants for a wide variety of major and minor automotive components. This will entail the use of lighter materials, such as aluminum and plastics as well as composite materials only now in the process of development. It will also require new components for the monitoring and control of various vehicular functions related to safety, clean air, and the efficient use of energy. A canvass of virtually all the automobile manufacturing corporations in the United States, Japan, Germany, France, Italy and Sweden revealed that very large new investments will be required for the manufacture of components over the next five to ten years to build the next generation of cars.

Canada has some definite advantages in competing for a share of this new business. As a major producer of aluminum and other light metals with a large and growing capacity for basic plastic materials and a good supply of energy at competitive prices, Canada has the basic requirements for the new generation of components. When to this is added a capable and plentiful work force, good location in relation to major markets in the U.S., proximity to tide-water for overseas customers, a highly competitive exchange rate, and a substantial domestic market for both cars and parts,

it would seem that a strong drive should be mustered to encourage the expansion of existing Canadian parts plants, to encourage Canadian entrepreneurs to enter this potentially lucrative business, and to attract investors from the U.S. and abroad.

Among the various barriers which obstruct the fuller development of the auto parts industry in Canada are the severe risks which are confronted in a market where the buyers are few and strong and the sellers numerous and not nearly as strong. Indeed, it is no exaggeration to say that the independent parts makers, particularly those that are based in Canada, are often at the mercy of their customers. In circumstances where rapid technological changes make these risks very real, there is often a reluctance to undertake the large investments required and there are practical problems in obtaining the equity and loan financing required.

It is understandable then that the auto parts industry should be pressing the government for special considerations — in the form of assured markets, and finance through government institutions at subsidized interest rates. The Commission does not believe that it is practical, at the present time, to negotiate for assured markets beyond those generated by the Auto Pact. Nor does it believe that a case has been made for government finance at lower than market rates of interests. It does believe, however, that good opportunities may be missed by the Canadian independents because of difficulties in obtaining financing for expansion or for new products.

As was noted earlier, Canada suffers a large and growing deficit in aftermarket components trade, despite the fact that this sector is protected by substantial tariffs. It bears repeating that independent Canadian manufacturers who produce exclusively for the aftermarket are the

least efficient sector of the automotive industry. It is apparent that a continuation of present policies and practices in this sector in the face of the changes anticipated in the market will simply perpetuate the problems and lead to declining production and employment. It is difficult to see why an extension to this sector of opportunities for specialization and export along the lines of the techniques embodied in the Auto Pact and applied to original component parts should not yield positive results.

Reference has been made in several chapters of this report to various "institutional barriers" which impede the fuller development of the automotive industry in Canada. Referred to most frequently by virtually every segment of the industry, is the fear that a sudden change in commercial policy may destroy the market for a major product, rendering a large capital investment worthless and sometimes threatening to bankrupt the company. This point was made to the Commission by institutions which are at present producing in Canada, as well as by potential investors from the U.S., Canada, Japan, Germany and other countries. Hard examples can be cited in this industry and in other manufacturing industries in Canada where this consideration has led to decisions against investing in Canada even where other factors including the return on investment were favourable to locating in Canada.

In the context of investment in Canada this worry, of course, surrounds the uncertainties associated with U.S. commercial policy -- or that of Canada itself arising out of possible disputes with the U.S. authorities. The application of countervailing duty in the Michelin Tire case, the threat of countervail in the Volkswagen case, and the world

cognizance of the not infrequent threats of restricting measures add credence to this fear and render this uncertainty a costly economic variable and a serious deterrent to investment in Canada.

It should be noted that it is not essential for many actual instances of restrictive trade actions to occur to convert this fear into a serious and costly barrier. It is sufficient for the threat to exist in the background and to be raised from time to time in Congressional or international debate for it to become an effective barrier. Indeed, it needs to be acknowledged that the U.S. Government has made the most sparing use of its countervailing or other powers to restrict trade. This, of course, is not the issue; the dog need not bite; he need only bark now or then — or perhaps simply be a dog that neither bites nor barks.

This problem is not new. It has been the subject of debate in Canada-U.S. trade relations over the years, and in the GATT and other international trade forums involving other major trading partners as well. Indeed, uncertainty about the U.S. countervailing law particularly in respect to the power of the U.S. executive branch to set aside its application in particular cases has become one of the serious obstacles to the completion of the current GATT multilateral tariff negotiations.

There is no easy answer to this problem, and only a long and consistent history of "abstinence" in the U.S. in particular will serve to overcome it. A novel proposal has been made in this report — included in the recommendations below — which may at least mitigate some of the adverse effects of uncertainty in commercial policy. It is being put forward on the assumption that the U.S. will, in practice, continue to

to be circumspect in the use of extraordinary barriers to trade, and that Canada will refrain from employing measures that blatantly invite that kind of response. Indeed, the proposal is designed in such a way that it can only be invoked in circumstances of fairly obvious departures from the application of agreed international trade rules.

Recommendations

There follows a list of recommendations drawn from the body of the Report. Although the Commission concluded that this is not an appropriate time to reopen the Auto Pact, there are a number of policy initiatives which do not require an immediate response from the U.S. or other trading partners and are believed not to entail serious risk of attracting an adverse reaction from them. While in some instances unilateral action is not likely to be as effective as joint action with our trading partners, time is very much of the essence in a rapidly changing automotive environment, and Canada does not really have a realistic alternative to early and effective measures. Also included are several recommendations of a negative character where it is suggested that the government refrain from certain policies which in the judgement of the Commission are likely to prove harmful.

Institutional

1. There is clearly a need for better data covering this industry than are generally available to governments and the public on a regular basis. The government should adopt a format for statistical analysis based

on the concepts which the Commission has outlined in this report with a view to providing a more comprehensive picture of developments in the trade and production in automotive products.

2. Because the automotive industry will be undergoing rapid change over the short to medium term, the industry should be reviewed at least on an annual basis. The Commission recommends that the government conduct such a review through the mechanism of an independent advisory body which would have the authority to make enquiries and advise the government on developments in the industry.

The Automotive Agreement

3. The Commission does not believe that this is a good time to attempt to re-negotiate the Auto Pact with the U.S. Government. The Commission recommends, therefore, that the safeguards under the Agreement, namely the assembly ratio, the CVA requirement and the "bogey", as well as the prohibition on imports of used cars and the restriction of duty-free imports to designated manufacturers, not be modified at the present time. They should be the subject of serious study in light of probable future negotiations.

Investment Climate

4. Potential investors tend to perceive a Canadian base for the North American market to be subject to the risk that commercial policy changes could disrupt sales to the U.S. market. In order

to offset this perception, the Commission recommends that the government implement a trade insurance program which will indemnify investors who are affected by unexpected changes in commercial policy.

5. The duty-remission program which the government negotiated with Volkswagen and which is being used as a model for other companies runs the risk of attracting countervailing duty. The Commission recommends that these programs be terminated and replaced by a program as outlined in 6.
6. The Commission recommends that vehicles made by producers in any country, which do not currently enjoy duty-free entry into Canada under the Auto Pact, be permitted duty-free entry if a "designated vehicle importer" acting on behalf of the foreign vehicle producer, achieves a Canadian Value Added (CVA) equal to 60-75 per cent of the cost of sales in Canada of the foreign producers' vehicles. The CVA may be achieved through the purchase of Canadian parts from independents or the "in-house" production of components in Canada.
7. Ad hoc grants to auto manufacturers to locate in prime industrial areas seriously undermine Canada's regional development objectives. The Commission recommends that the government try to obtain on a multilateral basis, or failing that, bilaterally with the U.S., agreement that governments will cease industrial subsidization as it applies to jurisdictions which do not merit special regional development considerations.

Industry Restructuring

8. The Commission believes that there are real opportunities for profitable new investments in the Canadian automotive parts industry and that adequate financial facilities may prove to be an obstacle.

Accordingly the Commission recommends that the government position itself to respond to the demand for loans or loan guarantees to this sector of the recently enlarged Enterprise Development Program. In the expectation that there will be large numbers of applications from automotive parts producers, the Commission recommends that the government prepare accordingly by assigning special officers who are competent and experienced in this field to handle such applications so that an effective and expeditious response can be made.

9. Despite continuing protection, Canada has suffered a chronic deficit in aftermarket parts. The Commission believes that rationalization of the aftermarket industry on a basis similar to that of the vehicles and original equipment markets is the best means of promoting internationally competitive production in this sector. Consideration should be given to an expansion of the "designated vehicle importer" concept to include aftermarket parts trade. "Designated parts importers" could import duty-free from the U.S.A. and overseas providing that they met an agreed upon CVA requirement. "Importers" in this category might include aftermarket parts manufacturers and distributors. Distributors of aftermarket parts would be required to at least maintain the historic ratio between their purchases of Canadian aftermarket parts and their total sales of these commodities in order to qualify.

10. The Commission recommends that a tariff provision be introduced for duty-free import of materials to be used in the production of Canadian automotive parts and accessories. This would take the form of a special end-use item along the lines of similar tariff items now available for the agricultural implements industry and certain other industries. This will enable auto parts producers to obtain their requirements at world competitive prices. This could be especially important for such new materials as light-weight alloys, and plastics which may well be the focus of parts materials in the future.
11. The implementation of the Commission's recommendations could result in significant restructuring of the automotive parts industry. It is recommended, therefore, that if the recommendations are adopted an assistance program be established to provide compensation for workers who are dislocated as a result of major industrial adjustments.

Research and Development

12. In recommendation number 8, the Commission proposed that officers who are competent and experienced in matters relating to auto parts manufacturing be assigned to the administration of applications from such firms for financial assistance under the Enterprise Development Program (EDP) in order that this activity be administered in an efficient and expeditious manner.

To give a new impetus to research, development and design activities in the Canadian automotive parts industry, it is proposed that the fund available under the EDP be substantially enlarged. Furthermore, it is proposed that the financial assistance available for individual firms also be enriched, particularly with respect to the smaller Canadian-owned operations.

With respect to the smaller parts makers, who have more limited financial and technical resources at their disposal, it is proposed that product development assistance take the form of grants to cover no less than 75 per cent of costs and for particularly promising ventures, where financing would be a burden, this assistance may be raised to cover full costs. Also, the Commission recommends that the test of "significant financial burden" that currently applies over the whole range of assistance and for all applicants be eliminated for the small independents.

For the foreign-owned parts makers, which for the most part are the large enterprises, the Commission recommends that the assistance take the form of forgivable loans, not to exceed 75 per cent of the cost of the development project. In all those instances where the project is a commercial success, the firm would be expected to repay

the loan in full with reasonable interest over a period of years.

On the basis of consultations with the industry, the Commission is concerned that the EDP embracing such a variety of industrial assistance and such a range of industries runs the risk of becoming unwieldy and excessively bureaucratic. Recommendation two proposed that an advisory body be established to conduct an annual review of developments pertaining to the automotive industry. The Commission recommends that this body also be charged with the task of reviewing the operations of the EDP as it relates to the automotive industry.

13. The Commission further recommends that vehicle producers be permitted to claim 200 per cent CVA credits under the Agreement for annual increases of R & D expenditures over a base period value.
14. In order to offset the higher equipment costs associated with R & D in Canada, the Commission recommends that two-thirds of the customs duties payable on equipment imported into Canada for R & D use be remitted.
15. The Commission recommends that a new section be added to the Program for Export Market Development to assist Canadian manufacturers in obtaining foreign technical "know-how" which can be adapted and developed in Canada.

16. Should the measures proposed by the Commission for increasing automotive R & D in Canada not prove effective, the government may wish to consider a more far reaching measure of a restraining nature to achieve the desired results, as described in chapter nine. Such measure might take the form of limiting the amount of R & D payments to foreign affiliates which may be deducted for tax purposes.

Multilateral Tariff Negotiations

17. The government is at present engaged in multilateral tariff negotiations under the G.A.T.T. in Geneva. It may be that consideration is being given by Canada to offering tariff reductions for motor vehicles and automotive parts in the context of these negotiations. The Commission is not in a position to judge whether such concessions may be justified in order to achieve a balanced overall agreement. However, the Commission is of the firm view that within the framework of the automotive industry itself such concessions would not be helpful. Indeed, the prospect of achieving expanded and new production and employment in Canada, which is the principal purpose of this Commission's recommendations, would be impeded if commitments were made to reduce M.F.N. tariffs on vehicles and parts at this time.

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A P P E N D I C E S

APPENDIX A-1

CANADIAN-U.S. TRADE IN AUTOMOTIVE PRODUCTS (AS REPORTED BY STATISTICS CANADA)

In Canadian \$ Millions	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977
<u>U.S. IMPORTS FROM CANADA</u>													
Motor Vehicles	95	488	995	1603	2267	2127	2536	2752	3060	3407	3790	4774	5996
Parts	151	339	512	846	1037	1127	1496	1778	2171	1953	2045	2942	3721
Tires and Tubes	4	9	13	9	5	15	8	22	68	64	68	163	144
Total	250	886	1520	2458	3309	3269	4040	4552	5299	5424	5903	7879	9861
<u>CANADIAN IMPORTS FROM U.S.</u>													
Motor Vehicles	154	384	720	998	1055	934	1321	1551	2082	2531	3126	3291	3948
Parts	797	1093	1314	1820	2307	2107	2485	2907	3553	3892	4522	5474	6847
Tires and Tubes	10	10	8	29	37	24	36	50	92	219	174	115	153
Total	961	1487	2042	2847	3399	3065	3842	4508	5727	6642	7822	8880	10948
<u>BALANCES</u>													
Motor Vehicles	(59)	104	275	605	1212	1193	1215	1201	978	876	664	1483	2048
Parts	(646)	(704)	(802)	(974)	(1270)	(980)	(989)	(1129)	(1382)	(1939)	(2477)	(2532)	(3126)
Tires and Tubes	(6)	(1)	5	(20)	(32)	(9)	(28)	(28)	(24)	(155)	(106)	48	(9)
Total	(711)	(601)	(522)	(389)	(90)	204	198	44	(428)	(1218)	(1919)	(1001)	(1087)

SOURCE: Statistics Canada

APPENDIX A-2

CANADIAN-U.S. TRADE IN AUTOMOTIVE PRODUCTS WITHIN AND OUTSIDE THE AUTOMOTIVE PRODUCTS TRADE AGREEMENT

In Canadian \$ Millions	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977
U.S. IMPORTS FROM CANADA												
Under APTA - Motor Vehicles	481.4	988.0	1588.0	2247.7	2115.4	2473.6	2738.1	3040.2	3391.0	3726.1	4703.6	5942.8
- Parts	338.8	458.2	789.4	953.6	1037.8	1386.2	1645.0	2048.0	1816.9	1909.2	2766.6	3488.4
- Sub-Total	820.2	1446.2	2377.4	3201.3	3153.2	3859.8	4383.1	5088.2	5207.9	5635.3	7470.2	9431.2
Outside APTA - Motor Vehicles												
- Parts	49.2	53.2	54.3	70.9	89.4	109.3	133.3	123.6	136.1	131.4	174.9	112.7
- Tires and Tubes	8.6	12.9	8.6	5.4	14.6	8.1	21.8	68.0	63.6	68.1	163.7	143.6
- Sub-Total	62.2	70.5	72.8	94.6	116.3	179.5	168.6	212.4	214.0	260.0	407.7	307.7
CANADIAN IMPORTS FROM U.S.												
Under APTA - Motor Vehicles	371.3	772.9	1073.4	1120.8	880.3	1283.6	1538.7	2010.1	2443.9	3000.3	3129.7	3846.1
- Parts	989.7	1216.0	1705.7	2168.2	2005.4	2313.5	2718.5	3236.3	3546.6	4039.9	4800.8	6218.3
- Sub-Total	1361.0	1988.8	2779.1	3289.0	2885.7	3597.1	4257.2	5246.5	5990.5	7040.2	7930.5	10064.4
Outside APTA - Motor Vehicles												
- Parts	132.1	140.0	149.4	196.6	183.3	213.6	237.6	303.8	341.4	356.6	578.8	511.7
- Tires and Tubes	9.7	7.6	29.1	36.8	24.0	36.4	50.5	92.0	218.1	172.8	114.4	153.1
- Sub-Total	180.3	183.9	216.2	290.0	272.9	325.6	375.3	489.9	667.6	807.0	894.5	871.0
BALANCES												
Under APTA - Motor Vehicles	110.1	215.1	514.6	1126.9	1235.1	1190.0	1199.4	1030.1	947.1	725.8	1573.9	2096.7
- Parts	(650.9)	(757.9)	(916.3)	(1214.6)	(967.6)	(927.3)	(1073.5)	(1188.3)	(1729.7)	(2130.7)	(2034.2)	(2729.9)
- Total	(540.8)	(542.7)	(401.7)	(87.7)	267.5	262.7	125.9	(158.2)	(782.6)	(1404.9)	(460.3)	(633.2)
Outside APTA - Motor Vehicles												
- Parts	(82.9)	(86.8)	(95.1)	(117.7)	(93.9)	(104.3)	(104.3)	(180.2)	(205.3)	(225.2)	(403.9)	(399.0)
- Tires and Tubes	(1.1)	5.3	(20.5)	(31.4)	(9.4)	(28.3)	(28.7)	(24.0)	(154.5)	(104.7)	49.3	(9.5)
- Total	(118.1)	(113.4)	(143.4)	(195.4)	(156.6)	(146.1)	(206.7)	(277.5)	(453.6)	(547.0)	(486.8)	(563.3)

SOURCE: Compiled from data in the "Commodity Imports by Tariff Item" Series, Statistics Canada, and various issues of the U.S. President's Report to the Congress on the Operations of the Canada-U.S. Automotive Agreement.

APPENDIX A-3

CANADA-OVERSEAS TRADE IN AUTOMOTIVE PRODUCTS (AS REPORTED BY STATISTICS CANADA)

In Canadian \$ Million	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977
CANADIAN EXPORTS												
Motor Vehicles	110	100	133	108	141	114	117	126	204	421	427	614
Parts	42	53	68	91	99	85	88	119	142	180	171	195
Tires and Tubes	4	4	3	2	3	4	3	5	5	5	8	7
Re-Exports	6	9	11	10	9	7	6	8	7	10	10	10
Total	162	166	215	211	252	210	214	258	358	621	615	826
CANADIAN IMPORTS												
Motor Vehicles	111	114	177	245	240	374	464	377	450	410	522	592
Parts	33	35	60	93	130	133	191	212	260	206	231	235
Tires and Tubes	5	7	10	13	19	27	42	57	70	82	79	110
Total	149	156	247	351	389	534	697	646	780	698	842	937
BALANCE												
Motor Vehicles	(1)	(14)	(44)	(137)	(99)	(260)	(347)	(251)	(246)	11	(95)	22
Parts	9	18	8	(2)	(31)	(48)	(103)	(93)	(118)	(26)	(60)	(40)
Tires and Tubes	(1)	(3)	(7)	(11)	(16)	(23)	(39)	(52)	(65)	(77)	(71)	(103)
Re-Exports	6	9	11	10	9	7	6	8	7	10	10	10
Total	13	10	(32)	(140)	(137)	(324)	(483)	(388)	(422)	(82)	(227)	(111)

SOURCE: Statistics Canada

APPENDIX A-4

SOURCE: See Appendix A2

SOURCE: See Appendix A2

APPENDIX B

CONSUMPTION, PRODUCTION AND THE TRANSFER VALUE OF MOTOR VEHICLES

The shares of consumption and production shown in Chapter 3 are based on information reported by the major manufacturers and data supplied by the Department of Industry, Trade and Commerce. U.S. manufacturers were asked to show transfer values on a uniform basis, namely that at which they transferred vehicles to their Canadian affiliates. This transfer value is determined by the company as the vehicle passes to the first level of distribution, which in most cases is another branch of the company.

Both cost of sales, which is the measure of consumption used, and Canadian value-added (CVA), the production measure, are defined in the tariff regulations relating to the Agreement. The CVA values have been reported on a model year basis (beginning August 1 of each year), while the transfer values reported to this Inquiry are on a calendar year basis.

As defined in Tariff Item 950, Canadian value added includes all costs related to assembly or original equipment parts production, e.g. parts and material for assembly, fuel, transportation, maintenance, depreciation, tools, dies, and jigs, research and design costs incurred in Canada, and general administration expenses related to

production, but not including the net profits of the vehicle manufacturer of either assembly or original equipment parts manufacture. Cost of sales is the amount charged at the first level of distribution in Canada. Normally the cost of sales includes all the production costs and some costs related to distribution and sales, as well as some profits charged. This is equivalent to the valuation of output transferred within the company, or transfer value.

APPENDIX C

EMPLOYMENT STATISTICS IN SELECTED SIC'S RELATED TO
THE AUTOMOTIVE INDUSTRY IN CANADA AND THE U.S.A.

1976

Employment in Canada

SIC 323-325	Motor Vehicles and Equipments	106,800
SIC 188	Automobile Fabrics Accessories	5,557
	Total SIC 323-325 and SIC 188	112,357

Employment in U.S.A.*

SIC 371	Motor Vehicles and Equipment	797,000
SIC 2396	Automotive Trim	20,000
SIC 3231	Glass Products (Automotive Portion)	2,000
SIC 3465	Automotive Stampings	123,000
SIC 3493	Steel Springs, except Wire (Automotive Portion)	5,000
SIC 3592	Carburetors, Pistons, Piston Rings and Valves (Automotive Portion)	25,000
SIC 3647	Vehicular Lighting Equipment (Automotive Portion)	12,000
SIC 3694	Electrical Equipment for Internal Combustion Engines (Automotive Portion)	46,000
SIC 3825	Instruments for Measuring and Testing of Electricity and Electrical Signals (Automotive Portion)	4,000
	Total U.S. Employment	1,034,000

NOTE: * On the basis of 1972 U.S. Standard Industrial Classification

SOURCE: Statistics Canada Catalogue Numbers 72-002 and 34-222 and
Bureau of Domestic Business Development,
Commerce.

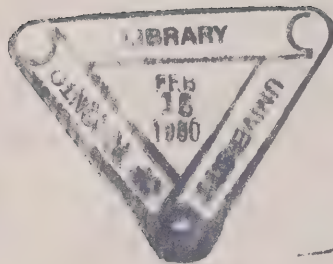
APPENDIX D
DETAILS OF CALCULATIONS

EXAMPLE I

Taxable income 1978	\$10,000,000
Current year R & D - \$1,000,000	
R & D expenditures in 3 previous years:	
1975 - \$400,000	
1976 - \$600,000	
1977 - \$800,000	
Three year average - \$600,000	
Add 5% special tax credit	<u>50,000</u>
Total income 1978	\$10,050,000
Less: Current year R & D - \$1,000,000	
plus 50% of difference between current	
year and average of preceding 3 years	
- \$200,000	<u>1,200,000</u>
	\$ 8,850,000
Assume combined federal and provincial	
tax rate is 50%	
$\frac{50}{100} \times 8,850,000 = 4,425,000 - 50,000 =$	4,375,000
Without the special credits (5% - 50%)	
the tax would be	
$\frac{50}{100} \times 9,000,000 = 4,500,000$	
Thus the saving is \$125,000 because of the special incentives.	

EXAMPLE 2

Taxable income 1978	\$10,000,000
Current year R & D - \$1,000,000	
R & D expenditures in 3 previous years:	
1975 - \$751,200	
1976 - \$826,400	
1977 - \$909,000	
Three year average - \$828,867	
Add 5% special tax credit	<u>50,000</u>
Total income 1978	\$10,050,000
Less: Current year R & D - \$1,000,000	
plus 50% of difference between current	
year and average of preceding 3 years	
- \$85,566	<u>1,085,566</u>
	\$ 8,964,434
Assume combined federal and provincial	
tax rate is 50%	
$\frac{50}{100} \times 8,964,434 = 4,482,217 - 50,000 =$	\$ 4,432,217
Thus the saving is \$67,783 because of the special incentives.	



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